

(26,030)

SUPREME COURT OF THE UNITED STATES.

OCTOBER TERM, 1917.

No. 563.

HENRY R. TOWNE, PLAINTIFF IN ERROR,

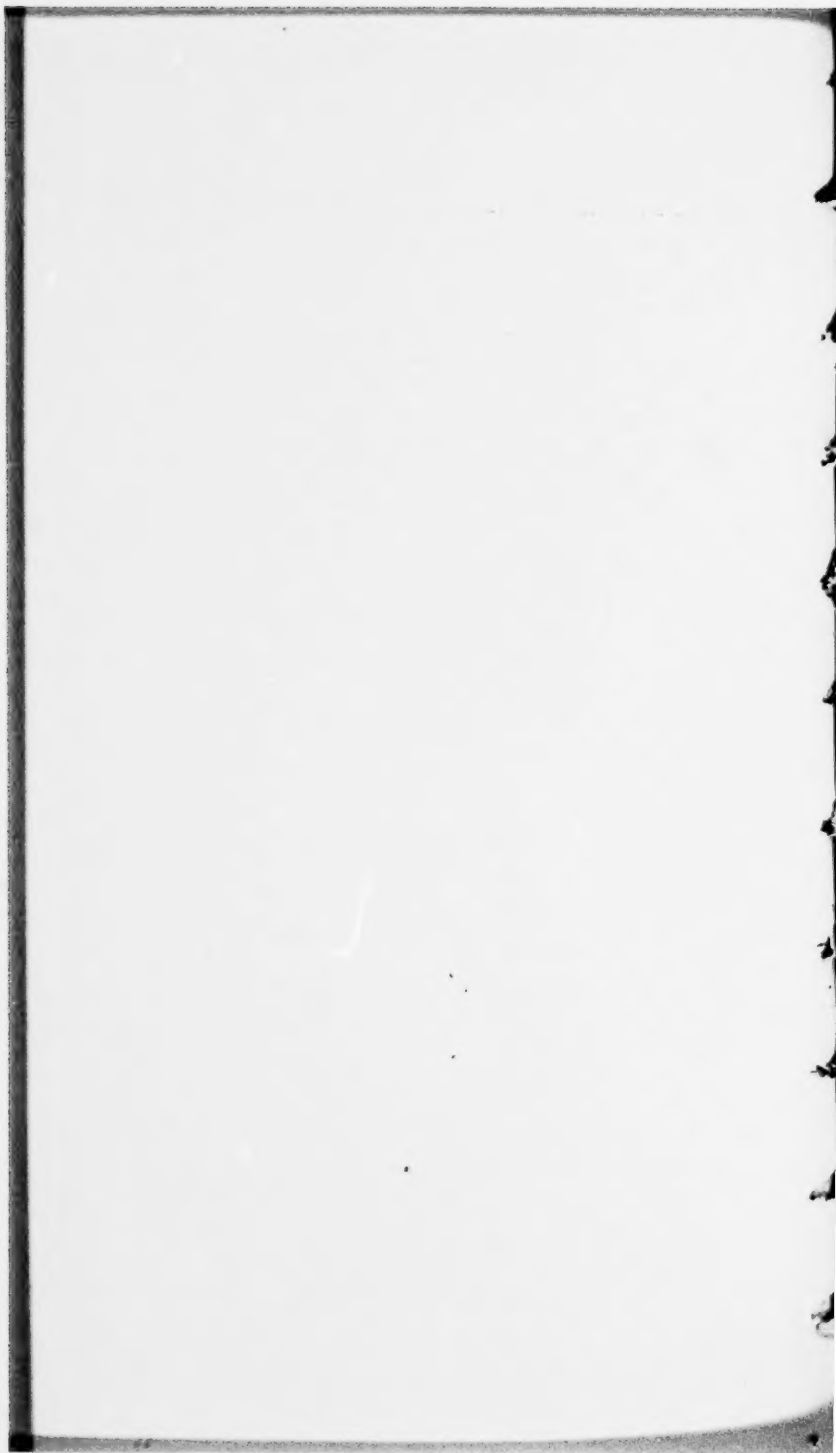
v.

MARK EISNER, COLLECTOR OF UNITED STATES INTERNAL REVENUE FOR THE THIRD DISTRICT OF THE STATE OF NEW YORK.

IN ERROR TO THE DISTRICT COURT OF THE UNITED STATES FOR THE SOUTHERN DISTRICT OF NEW YORK.

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1

Writ of Error.

L 16/273.

UNITED STATES OF AMERICA, ss:

The President of the United States of America to the Judges of the District Court of the United States for the Southern District of New York, Greeting:

Because, in the record and proceedings, as also in the rendition of the judgment of a plea which is in the District Court, before you, or some of you, between Henry R. Towne, plaintiff-in-error, against Mark Eisner, Collector of United States Internal Revenue for the Third District of the State of New York, defendant-in-error, a manifest error hath happened, to the great damage of the said Henry R. Towne, plaintiff-in-error, as is said and appears by his complaint, We, being willing that such error, if any hath been, should be duly corrected, and full and speedy justice done to the parties aforesaid in this behalf, Do Command You, if judgment be therein given, that then under your seal, distinctly and openly, you send the record and proceedings aforesaid, with all things concerning the same, to the Supreme Court of the United States, at the City of Washington, together with this writ, so that you have the same at the said place, before the Supreme Court of the United States aforesaid, on the 28th day of July, 1917, that the record and proceedings aforesaid being inspected, the said Supreme Court of the United States may cause further to be done therein, to correct that error, what of right and according to the law and custom of the United States ought to be done.

Witness, the Honorable Edward D. White, Chief Justice of the United States, this 29th day of June, in the year of our Lord one thousand nine hundred and seventeen, and of the Independence of the United States the one hundred and forty first.

[L. s.]

ALEX. GILCHRIST, JR.,

*Clerk of the District Court of the United States of
America for the Southern District of New
York, in the Second Circuit.*

The foregoing writ is hereby allowed.

MARTIN T. MANTON,

U. S. District Judge.

A. G., JR.

2 [Endorsed:] L 16—273. The Supreme Court of the United States. Henry R. Towne, Plaintiff in Error, vs. Mark Eisner, Collector of U. S. Internal Revenue for the Third Dist. of

the State of N. Y., Defendant in Error. Orig. Writ of Error. Louis H. Porter, Attorney for Plaintiff in Error, 140 Nassau Street, Borough of Manhattan, City of New York. U. S. District Court, S. D. of N. Y. Filed Jun-30, 1917. 110 K.

3 United States District Court, Southern District of New York.

L 16/273.

HENRY R. TOWNE, Plaintiff,

against

MARK EISNER, Collector of United States Internal Revenue of the Third District of the State of New York, Defendant.

Judgment of Dismissal.

The issues of law raised by the demurrer of the defendant to the second amended complaint of the plaintiff herein having duly come on to be heard before The Honorable Augustus N. Hand, United States District Judge, at a Stated Term of this Court, and after hearing Ben A. Matthews, Esq., Assistant United States Attorney, of counsel, in support of said demurrer, and Louis H. Porter, Esq., attorney for the plaintiff; Archibald R. Watson, Paul D. Cravath, George Welwood Murray and Charles Evans Hughes appearing by leave of the court as amici curiae in opposition thereto, and due deliberation having been had thereon, and the Court having handed down its opinion sustaining said demurrer, and an order having been duly entered on the 22nd day of June, 1917, sustaining the said demurrer to the second amended complaint of the plaintiff herein and ordering that the second amended complaint herein be dismissed, and further ordering that the defendant have final judgment on the merits against the plaintiff, and the defendant's costs having been taxed at the sum of \$32.60,

Now, on motion of Francis G. Caffey, United States Attorney for the Southern District of New York, attorney for the defendant, it is hereby

4 Ordered and adjudged that the defendant, Mark Eisner, Collector of United States Internal Revenue of the Third District of the State of New York, have final judgment against the plaintiff, Henry R. Towne, on the merits, and that the said defendant recover of the said plaintiff the sum of \$32.60, costs as taxed, and that execution issue therefor.

Judgment signed this 25th day of June, 1917.

ALEX GILCHRIST, JR., Clerk.

5 At a Stated Term of the United States District Court for the Southern District of New York, Held in the United States Courts and Post-Office Building, Borough of Manhattan, City of New York, on the 22 Day of June, 1917.

Present: Hon. Augustus N. Hand, U. S. District Judge.

L. 16/273.

HENRY R. TOWNE, Plaintiff,

against

MARK EISNER, Collector of United States Internal Revenue of the Third District of the State of New York, Defendant.

Order Sustaining Demurrer.

The issues of law raised by the demurrer of the defendant to the second amended complaint of the plaintiff herein, having duly come on to be heard by this Court, at a Stated Term thereof, and after hearing Ben A. Matthews, Esq., Assistant United States Attorney, of counsel, in support of said demurrer, and Louis H. Porter, Esq., Attorney for the plaintiff, and Archibald R. Watson, Paul D. Cravath, George Welwood Murray, and Charles Evans Hughes, appearing by leave of the Court as amici curiae, in opposition thereto, and due deliberation having been had thereon, and the Court having handed down its opinion sustaining said demurrer:

Now, upon motion of Francis G. Caffey, Esq., United States Attorney for the Southern District of New York, Attorney for the defendant, it is

Ordered that the said demurrer be and the same hereby is in all respects sustained; and it is

Further ordered that the second amended complaint herein be and the same hereby is dismissed; and it is

6 Further ordered that the defendant have final judgment against the plaintiff on the merits and for his costs to be taxed.

AUGUSTUS N. HAND,
U. S. District Judge.

6½

Summons—Law.

United States District Court for the Southern District of New York.

HENRY R. TOWNE, Plaintiff,
against

MARK EISNER, Collector of United States Internal Revenue for the
Third District of the State of New York, Defendant.

To the above-named Defendant:

You are hereby summoned to answer the complaint in this action, and to serve a copy of your answer on the plaintiff's attorney within twenty days after the service of this summons, exclusive of the day of service; and in case of your failure to appear, or answer, judgment will be taken against you by default for the relief demanded in the complaint.

Witness, the Hon. Learned Hand, Judge of the District Court of the United States for the Southern District of New York, at the City of New York, this 2nd day of March in the year one thousand nine hundred and seventeen.

[SEAL.]

ALEX GILCHRIST, JR., *Clerk.*

LOUIS H. PORTER,
Plaintiff's Attorney.

Office and Post-Office Address, 140 Nassau Street, Borough of Manhattan, New York City.

7 United States District Court, Southern District of New York.

L. 16/273.

HENRY R. TOWNE, Plaintiff,
against

MARK EISNER, Collector of United States Internal Revenue for the
Third District of the State of New York, Defendant.

Second Amended Complaint.

The plaintiff, for his second amended complaint herein, complaining of the defendant, by Louis H. Porter, his attorney, respectfully alleges:

I. At all the times hereinafter mentioned the plaintiff was and now is a citizen of the State of New York, and a resident of the Third Internal Revenue District of the State of New York,

II. At all the times hereinafter mentioned the defendant was and now is the Collector of United States Internal Revenue for the Third District of the State of New York.

III. The Yale & Towne Manufacturing Company is and was during the years 1913 and 1914 a corporation organized and existing under and by virtue of the laws of the State of Connecticut. On January 1st, 1913, said corporation had outstanding capital stock of two million dollars (\$2,000,000), divided into twenty thousand (20,000) shares of the nominal or par value of one hundred dollars (\$100) each. At said date the book value of the assets of said Company, excluding liabilities other than capital stock and surplus, amounted to \$5,728,526.36, the excess of said assets over the par value of its capital stock representing profits of the corporation which had been earned prior to January 1st, 1913, and invested by the Company in its business.

IV. At a meeting of the directors of said The Yale & Towne Manufacturing Company, held on the 11th day of December, 1912, after a consideration of the financial status of the Company, the directors informally and tentatively expressed an opinion favoring a declaration of a stock dividend of one hundred per cent. (100%), and a further increase of one million dollars (\$1,000,000) of capital stock to be issued for cash. In order that the subject might be more carefully studied it was resolved that it be referred to a committee for further report. Thereafter and on the 14th day of February, 1913, the Board of Directors of said The Yale & Towne Manufacturing Company adopted the following resolution:

"That the President of this corporation be and hereby is directed to call a special meeting of the stockholders of The Yale & Towne Manufacturing Company, for Thursday, March 13, 1913, at 2 o'clock, and further

"Resolved, That in the notice and call to be sent to stockholders of the said special meeting, the following business to be laid before said meeting shall be stated.

"To consider and act upon the following questions:

"1st. The increase of the capital stock of the Company by the issue of either common or preferred shares, or both, and if deemed expedient, to authorize and provide for such issue, and to determine the amount and terms thereof.

"2nd. To provide for the issue of bonds or other evidences of obligation or indebtedness of the Company, convertible into either such common or preferred stock, or the issue of scrip certificates convertible into either such common or preferred stock, as may be determined upon by said meeting, and the amount and terms thereof.

"3rd. The capitalization of a portion of the surplus of the corporation.

4th. The transfer to and merger into permanent capital of a portion of the surplus of the Company, and to determine the amount, terms and conditions of such transfer and merger.

"5th. To authorize and provide for the issue and distribution as a dividend among the stockholders of such stock to accomplish each and all of the purposes referred to in this call."

V. In pursuance of said vote of the directors, a special meeting of the stockholders of said corporation was duly held at the office of the Company, at Stamford, Connecticut, on March 13, 1913; and at such meeting the stockholders voted to authorize the issue of ten thousand (10,000) additional shares of common stock of the par value of one hundred dollars (\$100) each, to be sold for cash, the stockholders to be permitted to subscribe pro rata to their present holdings, and pay therefor at the rate of one hundred dollars (\$100) per share, any stock not so subscribed for by stockholders to be sold by the directors. In accordance with said vote the directors accordingly offered said stock for subscription to the stockholders; and the said ten thousand (10,000) shares, amounting to one million dollars (\$1,000,000), was accordingly subscribed and paid for by the stockholders, said payments being completed and the stock issued on or before the 10th day of October, 1913.

VI. At a meeting of the directors of said corporation, held on the 23rd day of September, 1913, a general discussion followed as to the advisability of declaring a stock dividend, and on motion it was resolved that a committee of three be appointed to investigate the subject and report at their convenience. At the meeting of the directors held on the 19th day of November, 1913, the committee so appointed at the meeting on September 23, 1913, made their report, which was accepted and placed on file. A copy of said
10 report is hereunto annexed and marked Exhibit A. It was thereupon voted

"That the President of this corporation be and hereby is directed to call a special meeting of the stockholders of The Yale & Towne Manufacturing Company for Wednesday, December 10th, 1913, And further

"Resolved, That in the notice and call to be sent to stockholders of the said special meeting, the following business to be brought before said meeting shall be stated:

"To consider and act upon the following questions:

"First. The increase of the capital stock of the Company by the issue of common shares, and if deemed expedient to authorize and provide for such issue, and to determine the amount and terms thereof.

"Second. To provide for the issue of scrip certificates convertible into such common stock as may be determined upon by said meeting, and the amount and terms thereof.

"Third. The capitalization of a portion of the surplus of the corporation.

"Fourth. The transfer to and merger into permanent capital of a portion of the surplus of the Company, and to determine the amount, terms and conditions of such transfer and merger.

"Fifth. To authorize and provide for the issue and distribution among the stockholders of such shares of stock or scrip to accomplish each and all of the purposes referred to in this call."

VII. In accordance with said resolution, a special meeting of the stockholders of The Yale & Towne Manufacturing Company was held on December 10, 1913; and thereafter and on the 17th day of

December, 1913, the directors of the said The Yale & Towne Manufacturing Company, in conformity with the authority thereto duly given them by the stockholders of said Company, adopted a resolution providing for a recapitalization of the corporation, which said resolution was as follows:

"Whereas, at a Special Meeting of the stockholders of The Yale & Towne Manufacturing Company, held in the City of Stamford, on December 10th, 1913, said meeting having been duly warned and called for the purpose of acting on said resolution, a formal resolution was duly passed, to wit,

"Voted, That it is desirable and this meeting doth authorize, approve and recommend the transfer to the amount of One Million Five Hundred Thousand Dollars (\$1,500,000) in value of a portion of the surplus, now utilized as working capital, to and the conversion and merger of the same into the permanent capital stock of this corporation by the increase of the capital stock in that amount, and the issue of fifteen thousand (15,000) additional shares, each of the par value of one hundred dollars (\$100), and the distribution thereof among the stockholders in the proportion of one new share to each two of the present outstanding capital stock; and in respect to any fractional interests arising upon such distribution in the case of holdings of less than two shares, and of holdings in excess of two shares, and not a multiple thereof, the issue of transferable scrip convertible upon combination and surrender into full shares of such new issue, the terms of which scrip are hereinafter set forth; and the transfer from the surplus account to the capital stock account of the said sum of One Million Five Hundred Thousand Dollars (\$1,500,000) in payment for such issue of increased capital stock and scrip. And it is further

"Voted, that the capital stock of this corporation be so increased from three million dollars (\$3,000,000) to four million five hundred thousand dollars (\$4,500,000) by the issue of said fifteen thousand (15,000) additional shares of stock, each of the par value of one hundred dollars (\$100), which additional shares, together with the present share capital, aggregating in the whole four million five hundred thousand dollars (\$4,500,000), shall be and remain common stock. And it is further

"Voted, that transferable scrip shall be issued to an amount equal to the aggregate of the par value of the shares of such new issue remaining after the apportionment of full shares to the stockholders in such distribution; such scrip shall be in denominations of fifty dollars (\$50), payable in money upon presentation and demand at the office of the corporation, or, at the option of the holder, and when combined with other such scrip, and all duly endorsed for assignment, into an aggregate amount of one hundred dollars (\$100) face value, or a multiple thereof, to be converted into stock of said new issue of the par value of the amount of such combined scrip, such right of conversion to expire at the end of sixty days from the date of issue of such scrip; and whenever a fraction shall result in the apportionment of such new stock to any stockholder, such scrip shall

be issued to him to the amount of the par value of such fractional part of a share. And it is further

12 "Voted, that after the expiration of the sixty days during which such conversion privilege shall be attached to such scrip, the right to subscribe at par to the shares of such new stock remaining unissued because of the failure of scrip holders to exercise such privilege of combination and conversion, shall after due notice be sold by the directors to the highest bidder."

"And whereas, a certificate of the increase of the capital stock so authorized has been made by the directors, and filed with and approved by the Secretary of State of the State of Connecticut, and the franchise tax for such increase, amounting to fifteen hundred dollars (\$1500) has been paid as required by law;

"Now therefore, it is voted that it is the judgment of the directors of this corporation that the actual surplus of this corporation, over and above all liabilities, capital stock included, exceeds the sum of One million five hundred thousand dollars (\$1,500,000); and

"Voted that one million five hundred thousand dollars (\$1,500,000) of the unissued authorized capital stock of this corporation be issued on January 2d 1914 to stockholders of record at the close of business December 26th, 1913, (the transfer books to be closed at 3 P. M. December 26th, 1913, and to re-open January 2d 1914), in the proportion of one new share for each two shares of the stock then standing in their names, and that whenever in the case of any stockholder such apportionment shall result in a fraction, transferable scrip shall be issued at the rate of fifty dollars (\$50) for each fraction equaling a half of a share, such scrip to be in the denomination of fifty dollars (\$50), and to be payable in money upon presentation and demand at the office of the corporation, or at the option of the holder, when combined with other such scrip, duly endorsed, into an aggregate amount of one hundred dollars (\$100) face value, or multiple thereof, to be converted into stock of said new issue of the par value of such combined scrip, such scrip to be issued concurrently with the full certificates of such new stock, and such right of conversion to expire at the end of sixty days from the date of issue of said scrip, and thereafter the right to subscribe at par to the shares of such new stock remaining unissued because of the failure of scrip holders to exercise such privilege of combination and conversion shall, after due notice, be sold by the directors to the highest bidder. And

13 "Voted, that in full payment for such issue of new stock and scrip under the provisions of the foregoing votes, the Treasurer be and he hereby is authorized and directed to transfer on the books of this corporation from surplus account to capital stock account and convertible scrip account, the sum of One million five hundred thousand dollars (\$1,500,000), and to credit such stockholder of record on said books his proportionate part of said shares and scrip."

VIII. Thereafter and in accordance with said resolution the officers of said The Yale & Towne Manufacturing Company transferred from its surplus account to capital stock account the sum of One million five hundred thousand dollars (\$1,500,000), and on the 2nd

day of January, 1914, issued to the stockholders of record of the said Company on the 26th day of December, 1913, additional shares of stock in the proportion of one share of new stock for each two shares of old stock held by each stockholder on said date.

IX. On the 26th day of December, 1913, the plaintiff was the owner of eight thousand three hundred forty-nine (8,349) shares of stock of The Yale & Towne Manufacturing Company; and on the 2nd day of January, 1914, in accordance with said readjustment of the capitalization of said Company, the plaintiff received from said Company certificates representing additional shares of stock amounting to four thousand one hundred seventy-four and a half (4,174½) shares of stock.

X. Because of the said readjustment of the capital of the said The Yale & Towne Manufacturing Company, and of the increase in the number of parts in which the ownership of the assets of the corporation, as represented by its capital stock, was divided, the asset or book value of each share of stock, representing an equal aliquot part in the said total assets of said Company, was proportionately decreased. The number of shares of stock owned by each stockholder

14 was increased by fifty per cent. (50%); and at the same time the market value of each share was correspondingly decreased; that is to say, that for the month prior to the closing of the books for said readjustment of capital on the 26th day of December, 1913, sales of the Company's stock had been made in the open market at a price of from \$175 to \$177 per share, and that for the month subsequent to said readjustment of capital sales of stock were made in the open market at from \$110 to \$130 a share, so that the value of the capital stock owned by each stockholder, including therein this plaintiff was substantially unchanged by reason of the said recapitalization and the receipt of said additional shares of stock. The rate of cash dividends paid by the said corporation was at the same time proportionately reduced from that which had been paid prior to said recapitalization,—that is to say, for a considerable period prior to said recapitalization the cash dividends of the Company had been paid quarterly at the rate of one and a half per cent. (1½%) regular and one per cent. (1%) extra per quarter, making total cash distributions of ten dollars (\$10) a share per annum; while subsequent to the said readjustment of capital, cash dividends were paid at the rate of one and three-quarters per cent. (1¾%) quarterly, or seven dollars (\$7) per share per annum, so that the amount of dividend income received by each stockholder, including therein this plaintiff, remained substantially the same as it had been before said recapitalization took place.

XI. The amount charged from surplus account and to the credit of the capital stock account of said corporation in payment of

15 said fifteen thousand (15,000) shares, amounting to One million five hundred thousand dollars (\$1,500,000) par value of new stock of said corporation, was constituted entirely of earnings of said corporation accumulated prior to January 1st, 1913.

XII. In accordance with the provisions of the Federal Income Tax Law, being Section 2 of the Act of Congress of October 3, 1913,

entitled, "An Act to Reduce Tariff Duties and to Provide Revenue for the Government and for Other Purposes," the plaintiff in 1915 duly filed his return of income received during the year 1914 and paid the tax assessed by the defendant as Collector of Internal Revenue for the Third District of New York thereon. In determining the amount of taxable income received by the plaintiff during the year 1914, and in ascertaining and fixing the income tax due thereon, the said four thousand one hundred seventy-four and a half ($4,174\frac{1}{2}$) shares of stock of The Yale & Towne Manufacturing Company received by the plaintiff as aforesaid were excluded.

XIII. Thereafter the defendant as Collector of United States Internal Revenue for the Third District of New York, claiming to act in pursuance of the provisions of the Act of Congress, being Section 2 of the Act of October 3, 1913, entitled, "An Act to Reduce Tariff Duties and to Provide Revenue for the Government and for Other Purposes," demanded of the plaintiff the sum of Twenty thousand two hundred eight and 94/100 Dollars (\$20,208.94), which the defendant claimed to be due and payable as an income tax on said four thousand one hundred seventy-four and one-half ($4,174\frac{1}{2}$) shares of stock of The Yale & Towne Manufacturing Company received by plaintiff as aforesaid in the year 1914, and which said stock the defendant claimed constituted taxable income, the said defendant having assessed said tax on the contention that for the purpose of the income tax the $4,174\frac{1}{2}$ shares of stock were legally equivalent to a cash dividend of \$417,450; and the defendant threatened to enforce the payment of said tax, together with the penalties and interest, as provided in the act, by distraint and sale of property; and thereupon the plaintiff, solely to avoid the imposition of the penalties and interest, and under compulsion, duress, and coercion, paid to the defendant as such collector, on or about the 7th day of June, 1916, the sum of Twenty thousand two hundred eight and 94/100 Dollars (\$20,208.94), but under protest, and at the same time protested in writing that no tax was due from the plaintiff, and that the defendant was without authority to exact and collect the same, and that plaintiff paid the same under duress and compulsion.

XIV. Thereafter the plaintiff duly took an appeal to the Commissioner of Internal Revenue and demanded repayment of said tax, in accordance with law and the regulations and rules of the Treasury Department. Said appeal was duly perfected and filed with the Commissioner of Internal Revenue on or before the 15th day of July, 1916. More than six months have elapsed since the taking and perfecting of said appeal, but said Commissioner of Internal Revenue has failed and neglected to decide the same, and the said appeal has not been decided or determined.

17 XV. Said shares of stock of The Yale & Towne Manufacturing Company so received by the plaintiff as aforesaid on the 2nd day of January, 1914, did not constitute taxable income under said Act of Congress; no tax was due or has since become due thereon to the United States Government or to the defendant as Collector of United States Internal Revenue for the Third District

of New York; and said sum of Twenty thousand two hundred eight and 94/100 Dollars (\$20,208.94) was illegally and without warrant or authority of law demanded and collected by the defendant from the plaintiff.

XVI. No part of said sum of Twenty thousand two hundred eight and 94/100 Dollars (\$20,208.94) has been repaid to the plaintiff, and the whole amount thereof, with interest thereon from the 7th day of June, 1915, remains due and owing from this defendant to this plaintiff.

XVII. This is a suit of a civil nature at common law; and the matter in controversy exceeds, exclusive of interest and costs, the sum of three thousand dollars (\$3,000), and this suit and the cause of action herein set forth arise under the Constitution and laws of the United States and under the laws of the United States providing for internal revenue.

XVIII. The Act of Congress under which said sum of twenty thousand two hundred eight and 94/100 Dollars (\$20,208.94) was levied and its payment compelled,—to wit, Sec. 2 of the Act of October 3, 1915, entitled "An Act to Reduce Tariff Duties and to Provide Revenue for the Government and for Other Purposes," is invalid and void, in so far as the same may be asserted to confer power to make such levy or to compel such payment, because in violation of the provisions of Article I, Sec. 2, Clause 3, of the Constitution of the United States to the effect that "direct taxes shall be apportioned among the several states;" and of the provisions of Article I, Sec. 9, Clause 4 thereof, to the effect that "no capitation, or other direct, tax shall be laid, unless in proportion to the census or enumeration hereinbefore directed to be taken;" and that the said Act as applied to the plaintiff as aforesaid did not lay a tax on income within the meaning of the provisions of the Sixteenth Amendment to the said Constitution to the effect that "The Congress shall have power to lay and collect taxes on incomes from whatever source derived without apportionment among the several states and without regard to any census or enumeration;" and this plaintiff hereby draws in question the constitutionality of the said Act of Congress and of all provisions thereof assumed or asserted to authorize the said levy and the enforcement thereof.

Wherefore, Plaintiff demands judgment against the defendant for the sum of Twenty thousand two hundred eight and 94/100 Dollars (\$20,208.94), with interest thereon from the 7th day of June, 1915, together with the costs and disbursements of this action.

LOUIS H. PORTER,

*Attorney for Plaintiff, 140 Nassau Street,
Borough of Manhattan, City of New York.*

19 STATE OF NEW YORK,
County of New York, ss:

Henry R. Towne, being duly sworn, deposes and says that he is the plaintiff herein, that he has read the foregoing second amended

complaint and knows the contents thereof, and that the same is true of his own knowledge except as to the matters therein stated to be alleged on information and belief, and that as to those matters he believes it to be true.

HENRY R. TOWNE.

Sworn to before me this 21st day of June, 1917.

[SEAL.]

JEANNE VOLLENHOVER,
Notary Public, New York County
No. 50, Register's No. 8045.

Term expires March 30, 1918.

NEW YORK, November 10, 1913.

To the Board of Directors:

Your Committee, appointed at the meeting of the Board of Directors of the Yale & Towne Manufacturing Company, held at the office of the company on September 23rd, 1913, to consider the advisability of appropriating a portion of the surplus of the company to permanent capital account and distributing to stockholders certificates of stock evidencing their ownership therein, and with further instructions, in case such a distribution would seem desirable, to recommend the amount of the same, beg to report as follows:

The deliberations of your Committee have covered a somewhat extensive field and it is deemed desirable that a full and detailed account of its work be given in this report that the same may be preserved in the company's files.

The question of the expediency of such a change in capitalization must be considered from two standpoints,—that of the corporation and that of the individual stockholders. So far as the corporation itself is concerned, the increased capital stock will mean slightly increased taxes in various states. These will probably amount to less than \$500 a year all told, and, therefore, are negligible.

It may be suggested that the enlarged outstanding capital stock would place an undue burden on the company in the maintenance of dividends. But we have no preferred stock, the rate of dividend is entirely optional,—except for the effect on the market price of

the company's shares, which is discussed at greater length
21 further on—and it hardly seems to us that, within the reasonable bounds we have been considering, such a suggestion is of any force.

As opposed to the theoretical objection on this ground, there are two very real advantages in the present temper of the public mind toward corporations. First, the payment of large annual cash dividends is more likely to incite attack by the Government authorities, upon one ground or another, and we are more likely to be able to continue our business free from annoyance and criticism, if our current dividend distribution does not exceed say 8% upon our

capital stock. A readjustment of capital is soon forgotten, whereas the quarterly payment of large cash dividends is a constant suggestion of undue profits.

Furthermore, our bonds mature in 1920 and from time to time the company has outstanding a limited amount of short term paper. While the primary question as to the market price of new bonds is the security pledged therefor and of commercial paper the credit and grade of receivables against which they are issued, nevertheless the amount of outstanding capital stock upon which dividends are paid has also a material bearing in affecting their market price. We believe that we would find a better range for a new issue of bonds if our capital stock was \$4,500,000 or \$5,000,000 than if our capital stock was but \$3,000,000, and similarly, a lower discount rate for our paper in times of depression.

For all these reasons we are of the opinion that, from the standpoint of the corporation, the arguments are on the whole in favor of a change in capitalization, the principal limitation thereon being that the increase thereof shall not be so great that we could not, with reasonable confidence, contemplate the continuance of dividends at a fair rate upon the increased capital stock.

22 The question as affecting the stockholders seems to us to be primarily one of the market value for their shares. The amount of cash distribution of dividends is not in any way directly connected with the amount of outstanding capital stock. In other words, it is our duty as Directors to determine what amount of cash dividend can properly be distributed, taking into account the earnings of the company, the rate thereof being merely the ratio that this sum bears to the company's outstanding capital stock.

The questions which seem to be important to consider in connection with the individual stockholders are:

1st. Would any increased burden be placed on them in connection with the new Federal Income tax from this recapitalization?

2nd. What effect this recapitalization would have on the market price of the stock?

3rd. Taking into account the various other considerations, if the capitalization is to be enlarged in what amount and at what time?

Our deliberations on this matter have been largely directed to these three points and the result of our deliberations is set forth as follows:

The question whether the proposed recapitalization would subject the individual stockholders to a claim on the part of the federal government that they were thereby made liable to the payment of the income tax, based on the amount of the increased capitalization, divides into two parts: 1st, whether the proposed recapitalization would be held to be income within the meaning of the federal income tax law, and 2nd, if the answer to this first question is in

23 the affirmative, whether income consisting of dividends of any kind is taxable under the law. Our counsel, having given this matter due consideration, is of the opinion that the answer to both of these questions is in the negative. The form of such recapitalization, as approved by the Connecticut Supreme Court, provided

for the appropriation of certain assets of the company, heretofore carried in surplus account, to permanent capital account. It is believed that the authorities, especially the United States Supreme Court, support the view that such recapitalization, with the attendant distribution to stockholders of certificates of stock representing their interest in the amount of capital thus permanently appropriated by the company, in no sense constitutes income within the meaning of the income tax law. Secondly, counsel is of the opinion that, from a careful study of the wording of the income tax law, taking into account the cardinal rule of taxation statutes that all questions of doubt must be resolved in favor of the tax payer, there is reason to believe that the courts will hold that dividends of corporations are wholly exempt from the income tax and that the exemption specifically provided in Paragraph B of the law is not limited to the normal tax of 1%. It is quite possible that the conclusion here expressed would not be accepted by the federal government without a litigation, but we feel that there is ground for believing that we would be successful in the event of such litigation.

The next point considered was whether, in the company's recent circular to its stockholders in connection with the proposed increase of its capital stock by \$1,000,000, or elsewhere, there was any possible commitment made which might be thought to morally bind the company to such a recapitalization as is under discussion. The con-

24 conclusion of your Committee was that undoubtedly such a moral obligation existed, but it appeared to them that should the proposed course be deemed in any way detrimental to the best interests of the company this moral obligation could be waived or released.

The next point considered was the present and future financial position of the company. In spite of the stockholders' recent subscription for \$1,000,000 additional capital, the company will probably be borrowing by the end of the year on its short term notes nearly \$900,000. This sum can of course be reduced gradually through surplus earnings should business continue satisfactory, but the possibility of having to liquidate all or a part of this debt through the sale of additional stock was considered.

An analysis of the company's effort to secure \$1,000,000 from its own stockholders this spring through the sale to them of 10,000 shares at 100 revealed the fact that on October 10th, 1913, 137 new stockholders had purchased over 41% of those shares, or 4,172 shares. In other words, less than 60% of this new money was contributed by the company's old stockholders.

As many of the company's oldest stockholders had increased their investment in the company's shares so recently through the exercise of their rights, it was considered unlikely that they would be in a position to avail of further similar privileges in the near future to any considerable extent, and while it was by no means decided that it would soon be necessary to raise additional capital through the sale of additional shares, it was deemed desirable to recommend that such steps be taken as would make your shares as attractive as possible in the eyes of the investing public.

25 While your company for many years has enjoyed the highest credit and your earnings have been good, there have been three primary drawbacks to your shares appealing to the investing public and to your company's obtaining its proper proportion of the funds annually seeking investment.

In the first place, your shares have rarely been available in the principal market place of this country in attractive amounts, nor has any systematic method been followed to make a market for them. They have usually been handled by the smaller so-called "outside" brokers, who circularize your list of stockholders but who otherwise do little distributing and by their methods and manners reflect but little credit to your company or its shares.

Steps have been taken recently to improve this condition, however, and it is hoped that such steps, so far as they go, will prove beneficial in this respect.

In the second place, it has never been the policy of your company to issue to its stockholders or the public any formal annual report. In this age of publicity, few industrial and no railroad companies omit this practice. With reasonable information available as to the earnings and financial condition of practically every other industrial concern of equal size and standing not only in pamphlet form but conveniently published in all the best financial reference books, it is not altogether surprising that the careful investor passes by the securities of a corporation about which no financial information is available save from interested or prejudiced sources.

While this feature was not intrusted to the deliberations of this Committee, it seemed to have a direct bearing on the work in hand, its discussion occupied part of its time, and it is accordingly respectfully suggested that hereafter a formal annual report be issued to your stockholders and the public, beginning with the current year.

26 We recommend that the first annual report contain a brief history of the company, a synopsis of its annual earnings for the past ten years, and its current balance sheet and income account, with the customary remarks by the President, and that this report be forwarded to the proper financial publications as well as to the company's stockholders.

It is also recommended that hereafter regular annual reports be published and distributed in like manner.

The third point was the market price of your shares. While high quotations have been maintained over a series of years and for the last three years the market for your stock has been quoted above \$200 per share, nevertheless it is true that these figures represent a market which was largely, if not entirely, nominal. In other words, at no time would the market have absorbed a large amount of shares at the quoted price, and if any considerable block of stock had been offered for sale a sudden and very sharp reduction in those quotations would have resulted before the sale of such block could have been completed in the public market. While with a company of this size no really broad market for its shares can be hoped for and while the market to-day for its shares is still largely nominal, we

believe that if your shares could be made available at a smaller premium than they have heretofore carried, they would appeal to a much larger number of outside investors. While no definite rule on this point has ever been established, it is believed to be a fair illustration to say that a stock selling at \$200 per share would attract three times as many investors as a stock selling at \$300 per share, the book value and earnings power of the two being, of course, proportionate; and a stock selling at \$100 per share would attract ten times as many investors as a stock selling at \$200.

The most popular price of an investment stock at the present time would be slightly below \$100, and many are available at such prices to-day. From the company's standpoint, however, it is highly desirable that your shares should always command a premium.

Under the law, no new stock may be issued for less than \$100 per share in cash or its equivalent, and your Committee is unanimously of the opinion that it would be most unwise to convert so large a portion of your company's surplus to fixed capital that its shares might not always command a reasonable premium.

A desirable range for your shares is believed to be between \$125 and \$150 in normal times, gradually appreciating to higher figures with better market conditions and accumulating undivided earnings or surplus.

It is believed by your Committee that could such a range be established for your shares the increased demand for the stock by the investing public would go a long way toward maintaining this level and the market correspondingly broadened. In other words, if your shares could be bought at a figure nearer \$100 than the present nominal quotation of \$175, they would be purchased by many investors who would not consider their purchase 50 or 100 points higher, and this would be so in spite of a slightly lower proportionate book value and investment return for the same.

Should your surplus account be charged with \$1,500,000 and this sum appropriated to permanent capital account, dividends on the increased capitalization at the rate of 6% per annum would call for but \$270,000, against present dividend requirements of \$300,000, or,

at 7% per annum, of \$315,000. While earnings for the present year are not available, it is believed to be safe to assume them at \$500,000. Assuming this figure, and taking the actual results of the preceding four years, the company's average net earnings for this period would be slightly over \$600,000 per annum, or at the rate of between 13% and 14% on the proposed new capitalization. Again assuming net earnings for the current year of \$500,000 and dividend requirements of \$300,000, the book value of the new stock would be about \$200 per share, including the item trade-marks and patents, or, excluding this figure, \$155 per share. At the present time your shares are quoted at 58% of the book value, including trade-marks, and 75% of the book value, excluding this item. An equivalent price for the new shares would be about 116.

From the standpoint of net return, your shares are to-day selling on approximately a 5.70% basis. As a 7% stock, the equivalent figure would be approximately 122.

It is the opinion of your Committee that, if a dividend of 7% per annum can be maintained on say \$4,500,000 of capital stock and your annual net earnings should equal the average net earnings for the past five years, your shares would command a premium of approximately 20 points, even in such period of business depression as those through which we have been passing of late. On the other hand, if dividends of 6% were paid, the increased demand for your shares as their market price approached 100 would be sufficient to maintain them at a small premium.

While it must be conceded that your Committee is powerless to forecast the future earning power of your company, it is a matter of record that the net earnings for the past ten years were at the average rate of over 10% on the capitalization of \$4,500,000 and in but one of the past ten years did the company fail to show net earnings of at least 6% thereon. In that year the return was about 5¼%.

Taking into consideration the substantial increase in the company's assets during this period, through the reinvestment in additional facilities of a large share of its actual earnings and the further amount of new capital which the stockholders subscribed this year, it is believed to be safe to assume that the company's earnings through the next decade should be somewhat better than during the last ten years, and that it is therefore unlikely that the company would find it embarrassing to maintain a dividend rate of at least 6% on \$4,500,000 stock.

There had been some discussion as to whether it would not be wise at this time, if a recapitalization of the company were to be made, to charge surplus account with \$2,000,000 and by this amount increase the company's outstanding stock to \$5,000,000. The objection to this plan is that a divided distribution of 7% on this enlarged capital would materially increase the cash dividend distribution, and should the dividend rate be less than that there would be danger that the market price of the stock would fall to 100 or less and make it difficult or impossible to market new stock under the existing laws if at any time it should be deemed advisable.

Your Committee, therefore, having in mind the desirability of broadening the market for your shares, but realizing the danger of jeopardizing their proper market premium, recommends that \$1,500,000 be charged to surplus account and credited to the permanent capital of the company, and that certificates of stock representing this permanent investment be distributed pro rata to the stockholders and that the directors cause the proper steps to be taken to accomplish this result.

We further recommend that this recapitalization be effected between January 1, 1914, and the ensuing annual meeting in March.

Respectfully submitted,

ROBERT STRUTHERS, JR.,
LOUIS H. PORTER,
JNO. B. MILLIKEN,

Chairman.

31 United States District Court, Southern District of New York.

L. 16/273.

HENRY R. TOWNE, Plaintiff,

v.

MARK EISNER, Collector Internal Revenue, etc., Defendant.

Demurrer to Second Amended Complaint.

The defendant demurs to the second amended complaint herein on the ground that as appears on the face thereof, it does not state facts sufficient to constitute a cause of action.

FRANCIS G. CAFFEY,
*United States Attorney for the Southern District
of New York, Attorney for Defendant.*

Office and Post-Office Address, U. S. Courts and Post-Office Building, Borough of Manhattan, City of New York.

Dated, New York, June 22, 1917.

32 STATE OF NEW YORK,
County of New York,
Southern District of New York, ss:

Ben A. Matthews, being duly sworn, deposes and says that he is an Assistant United States Attorney and as such has charge of the above entitled action; that the above demurrer is not interposed for delay, but he verily believes that the second amended complaint is bad in law.

BEN A. MATTHEWS.

Subscribed and sworn to before me this 22 day of June, 1917.

CARL BRECHER,
Notary Public,
Bronx County #72, N. Y. County #477.

33 *Opinion of Judge Hand Sustaining Demurrer to Second
Amended Complaint.*

"I have already considered the constitutional question in my opinion already rendered in this action and adopt the same as my opinion on the demurrer to the complaint as now amended.

June 22, 1917.

A. N. H."

34 United States District Court, Southern District of New York.

HENRY R. TOWNE, Plaintiff,

against

MARK EISNER, Collectors of United States Internal Revenue for the Third District of the State of New York, Defendant.

Copy Opinion.

Louis H. Porter, Attorney for plaintiff.

H. Snowden Marshall, United States Attorney, Attorney for Defendant, (Ben A. Matthews, Ass't U. S. Attorney, Counsel).

Archibald R. Watson, Paul D. Cravath, George Welwood Murray, and Charles E. Hughes, appearing by leave of the Court as Amici Curiae.

AUGUSTUS N. HAND, *District Judge:*

This is an action to recover income taxes paid upon stock dividends under protest. The directors and stockholders of the Yale & Towne Manufacturing Company having a surplus all of which was earned prior to January 1, 1913, voted on December 17, 1913, to transfer \$1,500,000, thereof to its capital account and to apply the same to the payment of an issue of 15,000 shares of new stock of the par value of \$100, a share and to distribute this stock pro rata among stockholders of record on December 26, 1913. The actual distribution was made January 2, 1914. The effect
35 of this resolution was to increase the capital stock from \$3,000,000, to \$4,500,000, par. The resolution under which the stock dividend was declared also provided for scrip redeemable at par for fractional shares. The plaintiff was a holder of 8,349 shares of stock of the company, and upon distribution of the stock dividend received 4,174½ more. A tax of \$20,208.94 was assessed upon his stock dividend which he paid under protest, and now sues to recover.

The Act of October 3, 1913, provides (Section B):

"* * * the net income of a taxable person shall include gains, profits, and income derived from * * * interest, rent, dividends, securities, or the transaction of any lawful business carried on for gain or profit, or gains or profits and income derived from any source whatever."

The ruling of the Treasury Department, Decision 2274 issued December 22, 1915, provides:

"Stock dividends paid from the net earnings or the established surplus or undivided profits of corporations * * * are held to be the equivalent of cash and to constitute taxable income under the same conditions as cash dividends."

Gains and profits from business can only be taxed under the present income tax act by virtue of ownership of the property from

which they are derived. They are not like excise taxes based upon the earnings of a business corporate or otherwise. They are direct taxes under the decision of the Supreme Court in *Pollock v. Farmers Loan & Trust Company*, 158 U. S. 601, and would have to be apportioned but for the recent enactment of the Sixteenth Amendment to the Constitution. This amendment provides that:

36 "The Congress shall have power to lay and collect taxes on income from whatever source derived without apportionment among the several states, and without regard to any census or enumeration."

Now it is manifest that the stock dividend in question cannot be reached by the Income Tax Act, and could not even though Congress expressly declared it to be taxable as income unless it is in fact income. It is likewise true that the word must be presumed to have been used in the Constitutional amendment and in the Act in the sense in which the Supreme Court had theretofore defined it if a judicial definition had been clearly given.

Kepner v. United States, 195 U. S. at p. 124.

Latimer v. United States, 223 U. S., at p. 504.

United States v. Baruch, 223 U. S. 191.

I cannot, however, accede to the contention of the plaintiff that stock dividends had received such a clear definition in the case of *Gibbons v. Mahon*, 133 U. S., 549. That like most, if not all, of the cases where the question has arisen involved the consideration whether stock dividends are principal or income in a litigation between a life tenant and remainderman. The stock dividend was there principally based upon a surplus earned prior to the creation of the trust which received it and the question involved was not whether or not the dividend was income, but whether it belonged to life tenant or remainderman. The Massachusetts Courts with a numerically small following have adopted the English rule and held all stock dividends to belong to the corpus of the trust fund as between life tenant and remainderman, while New York, New

37 Jersey, New Hampshire, Pennsylvania, Maryland, Wisconsin, and other states of the Union have adopted rules of apportionment. In the *Matter of Osborne*, 209 N. Y., 430, the New York Court of Appeals held that extraordinary dividends representing accumulated profits, whether distributable in cash or in the form of stock, are to be apportioned between the corpus of the trust and the income, in the proportion in which the surplus thus distributed has been earned before or after the creation of the trust fund.

These varying rules laid down for the guidance of trustees have been to a considerable extent rules of convenient administration. The English and Massachusetts law, which the Supreme Court adopted in *Gibbons v. Mahon*, *supra*, has the advantage of avoiding the difficulty and expense of investigating the facts upon which any apportionment must be based.

After the decision of *Lowry v. Farmers Loan & Trust Company*, 172 N. Y., 137, it was thought by many New York trustees that

extraordinary dividends, whether or cash or stock, if derived from an accumulation of corporate profits and thus appearing in the corporate resolutions, were distributable to the life tenant, irrespective of when they were earned. New York trustees began to rely upon this decision as laying down a definite, even if a rather unjust rule, when a series of cases of which the Matter of Osborne, *supra*, was the culmination practically, though not in terms, overruled *Lowry v. Farmers Loan & Trust Company*, and established the method of apportionment I have mentioned.

38 The cases relating to distribution of extraordinary dividends by trustees are particularly designed to keep the corpus intact under all circumstances and to furnish trustees with definite rules of conduct. A court may well hold that extraordinary dividends are always capital because it thinks that so much trouble and expense is avoided that this consideration outweighs occasional injustice to the life tenant. The Supreme Court laid stress upon this consideration in *Gibbons v. Mahon*, *supra*, and Mr. Justice Gray remarked that the method of apportionment could not " * * * without producing great embarrassment and inconvenience be left open to be tried and determined by the courts * * * and by a distinct and separate investigation * * * of the affairs and accounts of the corporation."

I confess that if strict justice between life tenant and remainderman is to be attained I can imagine no other method than that of apportionment possible. The criterion adopted in these cases between life tenant and remainderman does not necessarily depend on whether the extraordinary dividend is in general income or not, but upon the person to whom it should belong in view of the date of the creation of the trust. For this reason I cannot regard the decision in *Gibbons v. Mahon* as determining the present issues, or the language of the court there as being at most anything more than a dictum in respect to the matters here involved.

I can give little weight to the argument that the issue of the stock dividend did not affect the market value of the plaintiff's aggregate holdings, and that the distribution of 50% more stock to the stockholders lessened the market price of their original stock
39 33 1/3%. This would be true in case of any cash dividend extraordinary or even ordinary. The cash distributed, plus the market value of the stock after the dividend was paid, would ordinarily be equivalent in value to the stock before the dividend. But the objection seems impressive that the transaction in no wise affected what the stockholder already had except to give him additional pieces of paper evidencing his ownership. He does, however, have something different before and after receiving the additional stock. What was before a mere chance that he might receive his share of the surplus in cash dividends and a vague right to secure them if the directors withheld them in a way and to an extent that indicated bad faith is now converted into a permanent interest in the capitalized surplus. He has lost the chance of cash dividends and gained an interest in the corporate enterprise that cannot be taken away. This interest is derived from earnings and

may be really of much greater advantage to the stockholder than the possibility or right which he has lost. It becomes capital of the corporation, but in his hands it is income and in many respects resembles the common extraordinary cash dividend accompanied by a right to subscribe for additional stock at par to an amount equivalent to the dividend in cash. To say that this distribution is not income because he received no cash, and the intermediate step is not taken, is, to my mind, quite to disregard the real nature of the transaction. As Lord Eldon said in *Paris v. Paris*, 10 Vesey, Jr., p. 185, when discussing the converse of this case:

40 "as to the distinction between stock and money that is too thin; and if the law is that this extraordinary profit if given in the shape of stock shall be considered capital it must be capital if given as money."

See *Will of Pabst*, 146 Wise., 330.

The contention of plaintiff that corporate dividends are exempt not only from the normal, but from the supertax, is answered by the requirement in Paragraph A, subdivision 2, that for the supertax there shall be a return of "total net income from all sources corporate or otherwise." While I think the stock dividend is a dividend, it is taxable irrespective of whether it technically comes within the meaning of the word, because it represents "gains, profits, and income," and thus comes within the language of the Act.

I can see no distinction in theory between the present case and that of *Edwards v. Keith*, 231 Fed. 111, where the Circuit Court of Appeals for this Circuit held that commissions of an insurance broker earned before the Income Tax Act was passed, but received after, were subject to the Act, or the recent case of *Southern Pacific Co. v. Lowe*, 238 Fed. 847.

It is not important whether in any given case the present stock dividend would belong to the life tenant or remainderman of a trust. In either event within the meaning of the Income Tax Law it must be regarded as income whether it be added to the corpus of the trust or paid to the beneficiary.

The Circuit Court of Appeals for the Eighth Circuit in the case of *Lynch v. Turrish*, 236 Fed. 653, and *Lynch v. Ormby*, 41 236 Fed. 661, use language inconsistent with the conclusion

I have reached in discussing extraordinary cash dividends paid from moneys received by a corporation prior to the time the Income Tax Act went into effect. These dividends, however, were not derived from corporate earnings, but from appreciation of capital which had been converted into cash. They were, therefore, in so sense income and were not subject to a tax as the Supreme Court had already held in the case of *Gray v. Darlington*, 15 Wall. 65, in construing the old income tax act passed during the Civil War.

The recent case of *Bruchaber v. Union Pacific R. R.*, 240 U. S., 1, held, following *Stockdale v. Insurance Companies*, 20 Wall. 323, that the Income Tax Act under consideration could not be assailed because of its retroactive character and that Congress could impose

tax upon income even when received during a portion of the year prior to the passage of the act.

The stock dividend in question, or an equivalent cash dividend, could not belong to the stockholder until declared by the Board of directors, so that it was in no proper sense income of the stockholder until that time.

If deferred payments for commissions which were earned prior to the date of the act, but not payable until after it went into effect were taxable as income when received under the rule laid down in *Edwards v. Keith*, supra, a fortiori is a dividend taxable as income when received, even though paid out of a surplus accumulated prior to the passage of the act, since at no time is there any legal right to the dividend vested in the stockholder until it has actually been declared. Such was the interpretation passed upon the Wisconsin Income Tax Act by the Supreme Court of that state in the case of *Van Dyke v. City of Milwaukee*, 159 Wis., 460. There dividend paid after the act went into effect out of surplus earned prior to that time was held taxable.

The whole matter turns on the new rights which the stockholder gets by the declaration of the stock dividend. The market value of the totality of his holdings may for the time remain the same as before. But as the New York Court of Appeals in the case of *Williams v. Western Union*, 93 N. Y. 162, said when speaking of the surplus of the Western Union before the declaration of a stock dividend:

"* * * It was not beyond the reach of the dividend making power of the directors."

but after the dividend was declared

so far as the solvency and responsibility of a corporation is concerned, they are increased * * * where it has a surplus of property to correspond to the amount of shares issued. In such case the surplus property is secured and impounded for the benefit of the creditors of the corporation and for the public, so that thereafter it can never be legally divided, withdrawn, or dissipated in any way."

The new stock purchased and paid for out of earnings which have been added permanently to capital is as truly income of the stockholder as the cash from which it was derived was income of the corporation. This cash has by the action of the directors become capital of the corporation, but in its place the stockholder has received new shares representing a permanent interest in the company not subject to abatement by dividend distributions which have a value capable of realization in cash. His rights are different from those he had before the dividend was declared and the shares of stock evidencing the new appropriation of the earnings and creating the new rights are income.

It may be said that in *Edwards v. Keith*, supra, moneys representing income had not yet come in, whereas in the case at bar they were in the hands of the corporation. Such a distinction, however, treats the stockholder as though he were entitled to a dividend if the money were in the treasury of the corporation. That such is not the correct rule is a principle permeating the whole law of corporations.

To go counter to it here would be to require investigations in every case as to when the property out of which dividends are paid accrued to the corporation itself. Indeed, the very year the Income Tax Act was passed it probably was true that a good many of the corporations which were paying their regular dividends were not earning them, but were paying them out of *passed* earnings. Can it be supposed for a moment that Congress intended to require no Income Tax of the citizen because the regular dividend he received would not have been received at all if it had depended upon the earnings of the corporation during that year? The real stumbling block which affects every one, and I confess has affected me, is the taxation of very large accumulations of earnings distributed by corporations after the passage of the Act. Certainly a mere matter of size can make no difference in determining whether the property taxed is income or not. The doubt I have felt in reaching my conclusion has not been due to the nature of stock dividends, but to the difficulty which

44 Judge Sanborn found in *Lynch v. Turrish*, *supra*, in determining whether Congress intended to tax earnings at all which had accrued in the hands of the corporation prior to the passage of the act, but were distributed later. In other words, in determining whether practically to ignore the corporate form and treat earnings whenever distributed as though declared in law at the time they were earned.

The Federal income tax act passed October 8th, 1913, providing that a cash or stock dividend payable out of earnings since March 1st, 1913, shall be considered income has no bearing upon this case. It may be argued that it was a limitation or extension of the income taxable by the Act under consideration, but in neither event can it be held to define the income which was theretofore taxable.

I can have no doubt that the Act of Congress taxing the dividends in question is constitutional for they possess the real essentials of income. The action of the officials in assessing and collecting the tax was authorized. The plaintiff has established no claim to a repayment of it, and the demurrer to his complaint is sustained.

Dated June 15, 1917.

A. N. H., D. J.

45 United States District Court, Southern District of New York.

L 16—273.

HENRY R. TOWNE, Plaintiff,

against

MARK EISNER, Collector of United States Internal Revenue for the
Third District of the State of New York, Defendant.

Petition for Writ of Error.

To the United States Supreme Court:

The above named Henry R. Towne now appears before this Court and complains that in the records and proceedings had in this cause, and also in the rendition of the judgment in the above entitled cause in the United States District Court for the Southern District of New York, on the 25th day of June, 1917, manifest error hath happened to the great damage of said plaintiff, all of which will more in detail appear from the assignment of errors which is filed with this petition.

Wherefore, the said plaintiff hereby prays for the allowance of a writ of error for an order fixing the amount of the bond for a supersedeas in said cause, and for such other order and process as may cause the aforementioned errors and judgment to be corrected by the said United States Supreme Court.

Dated, New York, June 29, 1917.

LOUIS H. PORTER,
Attorney for Plaintiff.

140 Nassau Street, Borough of Manhattan, City of New York.

Order Allowing Writ of Error.

At a Stated Term of the District Court of the United States, Held in and for the Southern District of New York, at the Court House in the United States Post Office, at the Court House Building, in the Borough of Manhattan, City of New York, on the 29 day of June, 1917.

Present: Hon. Martin T. Manton, U. S. District Judge.

L 16—273.

HENRY R. TOWNE, Plaintiff,

against

MARK EISNER, Collector of United States Internal Revenue for the Third District of the State of New York, Defendant.

The above named plaintiff, Henry R. Towne, having filed a petition for a writ of error and an assignment of errors in the above entitled action, and having also filed a bond in the sum of Two hundred and fifty dollars (\$250), and the said bond having been fully approved by the Court, it is now

Ordered That a writ of error be and the same hereby is allowed to have reviewed in the United States Supreme Court the record and proceedings and the judgment heretofore and on the 25th day of June, 1917, rendered in this court in this case. And it is further

Ordered That said bond shall operate as a supersedeas bond.

MANTON, D. J.

47 United States District Court, Southern District of New York.

L 16—273.

HENRY R. TOWNE, Plaintiff,

against

MARK EISNER, Collector of United States Internal Revenue for the Third District of the State of New York, Defendant.

Assignment of Errors.

The plaintiff above named hereby assigns error to the record and proceedings and to the entry of the judgment in the above entitled cause as follows:

I. The Court erred in sustaining the demurrer to the complaint.

II. The Court erred in holding that the tax alleged in the complaint was not a violation of Article I, Section 9 of the Constitution

of the United States as a direct tax on capital not laid in proportion to the census or enumeration therein mentioned.

III. The Court erred in holding that the tax alleged in the complaint was not a violation of Article I, Section 2 of the Constitution of the United States as a direct tax not apportioned among the several states.

IV. The Court erred in holding that the tax alleged in the complaint was a tax on income within the meaning of the Sixteenth Amendment to the Constitution of the United States.

V. The Court erred in holding that the tax alleged in the complaint was a tax on income within the meaning of the Income Tax Law of October 3, 1913.

48 VI. The Court erred in holding that a stock dividend constituted taxable income.

VII. The Court erred in holding the shares of stock received by the plaintiff on the readjustment of the capitalization of The Yale & Towne Manufacturing Company were a stock dividend.

VIII. The Court erred in holding that dividends of corporations were not exempt from both the super-tax and the normal tax under the provisions of the income tax law of October 3, 1913.

IX. The Court erred in holding that stock distributed to stockholders of corporations, representing the capitalization of profits earned prior to March 1, 1913, were taxable as income.

X. The Court erred in holding that profits of a corporation earned prior to March 1, 1913, constituted taxable income to the individual stockholders if distributed to them by the corporation subsequent to that date.

Dated, New York, June 29th, 1917.

LOUIS H. PORTER,
Attorney for Plaintiff.

140 Nassau Street, Borough of Manhattan, City of New York.

[Endorsed:] Copy. Assignment of Errors.

49 District Court of the United States of America for the Southern District of New York in the Second Circuit.

HENRY R. TOWNE, Plaintiff-Appellant,
against

MARK EISNER, Collector of the United States Internal Revenue of the Third District of the State of New York, Defendant-Respondent.

Bond on Appeal.

Know all men by these presents, That Henry R. Towne as principal, and National Surety Company, a corporation under the laws of the State of New York, with its principal place of business at No.

115 Broadway, in the City, County and State of New York, as surety, are held and firmly bound unto the above named Mark Eisner, Collector of the United States Internal Revenue of the Third District of the State of New York in the sum of Two Hundred and Fifty (\$250.00) Dollars to be paid to the said Mark Eisner, Collector of the United States Internal Revenue of the Third District of the State of New York for the payment of which well and truly to be made, said principal and surety bind themselves, their heirs, executors, administrators and assigns, jointly and severally, firmly by these presents. Sealed and dated the 28th day of June 1917.

Whereas, the above named Henry R. Towne has prosecuted a writ of error to the Supreme Court of the United States to reverse the final judgment rendered in the above entitled suit, by a Judge of the District Court of the United States for the Southern District of New York.

Now, therefore, the condition of this obligation is such, that if the above named Henry R. Towne shall prosecute said writ to effect, and answer all damages and costs if he fails to make said appeal good, then this obligation shall be void, otherwise the same shall be and remain in full force and virtue.

[L. S.]

HENRY R. TOWNE,
NATIONAL SURETY COMPANY,
By WM. A. THOMPSON,
Resident Vice-President.

Attest:

E. M. McCARTHY,
Resident Assistant Secretary.

STATE OF CONNECTICUT,

County of Fairfield, Stamford, ss:

On this 29 day of June, 1917, before me personally came the within named Henry R. Towne, to me known, and known to me to be the individual described in and who executed the within bond and he acknowledged that he executed the same.

[L. S.]

HAROLD S. WISDOM,
Notary Public.

50 *Affidavit, Acknowledgment, and Justification by Guarantee or Surety Company.*

STATE OF NEW YORK,

County of New York, ss:

On this 28th day of June 1917, before me personally came Wm. A. Thompson, known to me to be the Resident Vice-President of National Surety Company, the corporation described in and which executed the foregoing Bond of Henry R. Towne as surety and who, being by me duly sworn, did depose and say that he resides in the

City of New York, State of New York; that he is the Resident Vice-President of said Company, and knows the corporate seal thereof; that the said National Surety Company is duly incorporated under the laws of the State of New York, that said Company has complied with the provisions of the Act of Congress of August 13, 1894, that the seal affixed to the within Bond of Henry R. Towne is the corporate seal of said National Surety Company, and was thereto affixed by authority of the Board of Directors of said Company, and that he signed his name thereto by like authority as Resident Vice-President of said Company, and that he is acquainted with E. M. McCarthy and knows him to be the Resident Assistant Secretary of said Company; and that the signature of said E. M. McCarthy subscribed to said Bond is in the genuine handwriting of said E. M. McCarthy, and was thereto subscribed by order and authority of said Board of Directors, and in the presence of said deponent; and that the assets of said Company, unencumbered and liable to execution exceed its debts and liabilities of every nature whatsoever, by more than the sum of Eight Million dollars.

WM. A. THOMPSON,
(Deponent's Signature.)

Signed, sworn to, and acknowledged before me this 28th day of June, 1917.

[SEAL.]

F. E. FIELDS,
*Commissioner of Deeds, City of
New York, New York County
Clerk's No. 183.*

My commission expires Sept. 12, 1918.

[Endorsed:] L. 16-273. District Court of United States, Southern District of New York. Henry R. Towne, Plaintiff-Appellant, against Mark Eisner, Collector of the United States Internal Revenue of the Third District of the State of New York, Defendant-Respondent. (Office Copy.) Bond on Appeal. Surety. National Surety Company. A copy of the within paper has been this day received at this office. Jun-30, 1917. Francis G. Caffey, U. S. Attorney. I approve of the written Bond, and of the sufficiency of the surety thereon. Manton, U. S. D. J. 6/29/17.

Citation on Appeal.

L. 16-273.

By the Honorable Martin T. Manton, one of the Judges of the District Court of the United States for the Southern District of New York, in the Second Circuit.

To Mark Eisner, Collector of United States Internal Revenue for the Third District of the State of New York, Greeting:

You are hereby cited and admonished to be and appear before the United States Supreme Court, to be holden at the City of Washington, on the 28th day of July, 1917, pursuant to a writ of error filed in the Clerk's Office of the District Court of the United States for the Southern District of New York, wherein Henry R. Towne is plaintiff-in-error, and you are defendant-in-error, to show cause, if any there be, why the proceedings and judgment in said writ of error mentioned should not be corrected and speedy justice should not be done in that behalf.

Given under my hand at the Borough of Manhattan, in the City of New York, in the District and Circuit above named, this 29th day of June, in the year of our Lord One Thousand Nine Hundred and Seventeen, and of the Independence of the United States the One Hundred and Forty-first.

MARTIN T. MANTON.

*Judge of the District Court of the
United States for the Southern
District of New York, in the
Second Circuit.*

A. G., JR.

52 [Endorsed:] L. 16-273. United States Supreme Court.

Henry R. Towne, Plaintiff-in-error, vs. Mark Eisner, Collector of U. S. Internal Revenue for the Third Dist. of the State of N. Y., Defendant-in-error. Orig. Citation. Louis H. Porter, Attorney for Plaintiff-in-error, 140 Nassau Street, Borough of Manhattan, City of New York. Due service of a copy of the within Citation is hereby admitted this — day of —, 191—. A copy of the within paper has been this day received at this office Jun- 30, 1917. Francis G. Caffey, U. S. Attorney. K. U. S. District Court, S. D. of N. Y. Filed Jun- 30, 1917.

53

Stipulation on Appeal Record.

United States District Court, Southern District of New York.

L. 16—273.

HENRY R. TOWNE, Plaintiff,

vs.

MARK EISNER, Collector of United States Internal Revenue for the
Third District of the State of New York, Defendant.

It is hereby Stipulated and Agreed, that the foregoing is a true transcript of the record of the said District Court in the above-entitled matter as agreed on by the parties.

Dated New York, July 2nd, 1917.

LOUIS H. PORTER,

Attorney for Plaintiff.

FRANCIS G. CAFFEY,

*United States Attorney,**Attorney for Defendant.*

O. K.

B. A. M.

54

[Endorsed:] United States District Court, Southern District of New York. Henry R. Towne, Plaintiff, vs. Mark Eisner, Collector of U. S. Internal Revenue, etc., Defendant. Orig. Stipulation as to Correctness of Appeal Record. Record certified — — —, 191—. — — — —, Clerk. Louis H. Porter, Attorney for Plaintiff, 140 Nassau Street, Borough of Manhattan, City of New York.

55

UNITED STATES OF AMERICA,

Southern District of New York, ss:

L. 16—273.

HENRY R. TOWNE, Plaintiff,

vs.

MARK EISNER, Collector of United States Internal Revenue for the
Third District of the State of New York, Defendant.

I, Alexander Gilchrist, Jr., Clerk of the District Court of the United States of America for the Southern District of New York, do hereby Certify that the foregoing is a correct transcript of the record of the said District Court in the above-entitled matter as agreed on by the parties.

In Testimony whereof, I have caused the seal of the said Court to be hereunto affixed, at the City of New York, in the Southern District of New York, this 2nd day of July, in the year of our Lord one thousand nine hundred and seventeen and of the Independence of the said United States the one hundred and forty-first.

[Seal District Court of the United States, Southern District
of N. Y.]

ALEX. GILCHRIST, JR., *Clerk*.

56 [Endorsed:] United States Supreme Court. Henry R. Towne, Plaintiff-in-error, against Mark Eisner, Collector of United States Internal Revenue for the Third District of the State of New York, Defendant-in-error. Record on Appeal. Louis H. Porter, Attorney for Plff-in-error, 140 Nassau Street, Borough of Manhattan, City of New York. Francis G. Caffey, United States Attorney, Attorney for Defendant, U. S. Courts & Post Office Bldg., Borough of Manhattan, City of New York.

Endorsed on cover: File No. 26,030. S. New York D. C. U. S. Term No. 563. Henry R. Towne, plaintiff in error, vs. Mark Eisner, collector of United States Internal Revenue for the Third District of the State of New York. Filed July 10th, 1917. File No. 26,030.

OFFICE SUPREME COURT, U. S.
FILED
SEP 28 1917
JAMES D. MAHER
CLERK

No. 563.

IN THE
Supreme Court of the United States,
OCTOBER TERM, A. D. 1917.

HENRY R. TOWNE,

Plaintiff-in-Error,

against

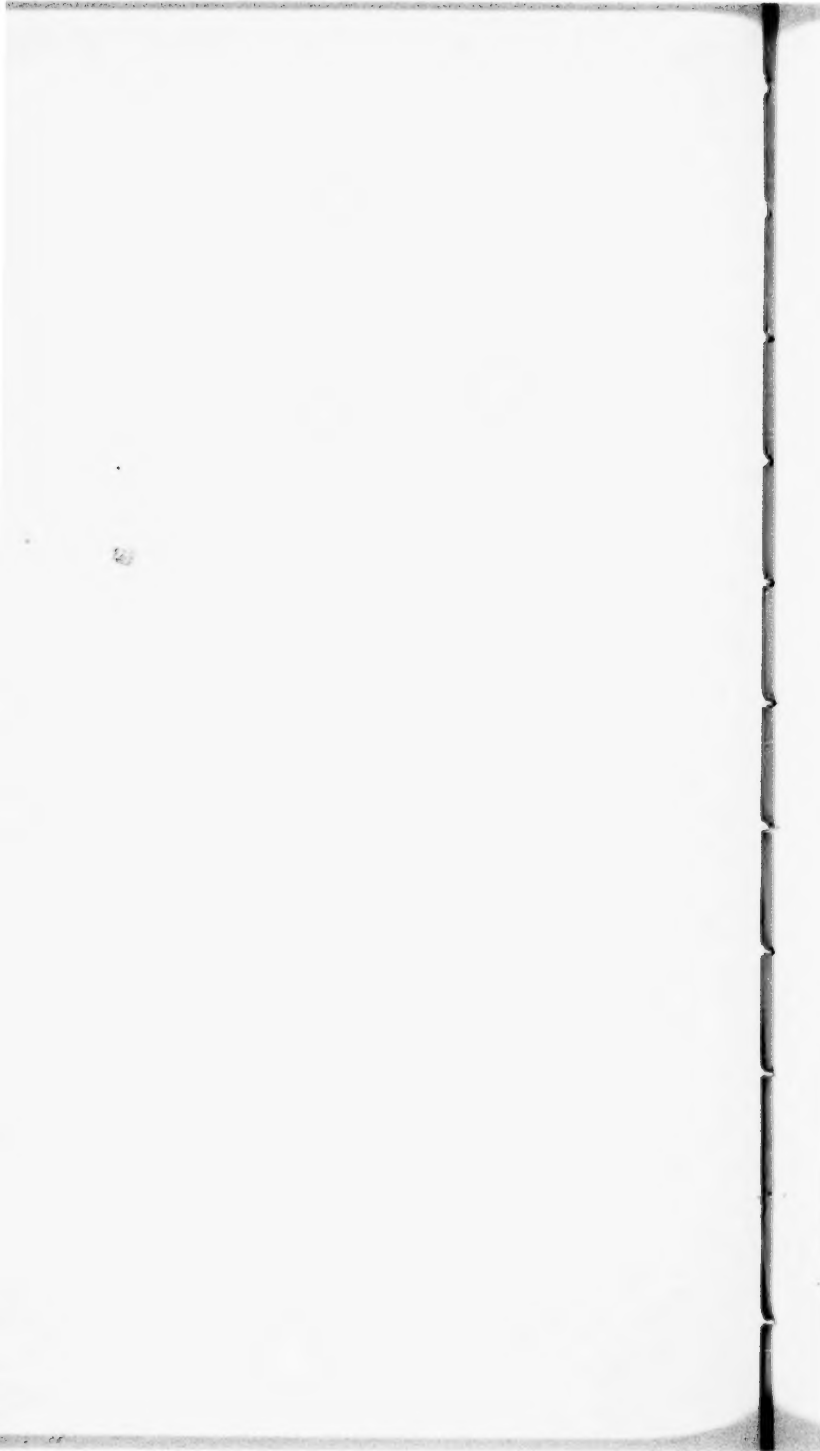
MARK EISNER, COLLECTOR, ETC.,

Defendant-in-Error.

MOTION TO ADVANCE.

CHARLES E. HUGHES,
GEORGE WELWOOD MURRAY,
CHARLES P. HOWLAND,
LOUIS H. PORTER,

Counsel for Plaintiff-in-Error.



IN THE
Supreme Court of the United States,
October Term, A. D. 1917.
No. 563.

HENRY R. TOWNE,
PLAINTIFF-IN-ERROR,
AGAINST

MARK EISNER, COLLECTOR, ETC.,
DEFENDANT-IN-ERROR.

MOTION TO ADVANCE.

NOW COMES HENRY R. TOWNE, THE PLAINTIFF IN ERROR, AND
MOVES THE COURT THAT THIS CAUSE BE ADVANCED ON THE DOCKET
AND SET DOWN FOR HEARING UPON A DAY CERTAIN.

STATEMENT OF FACTS.

The writ of error in this case is brought to review
the final judgment of the United States District Court
for the Southern District of New York, entered upon
an order sustaining defendant's demurrer to the second

amended complaint. The action was brought by a taxpayer to recover a tax assessed under the Income Tax Law of 1913, on the ground that it was illegally assessed. The plaintiff paid the tax under protest and took an appeal in due time to the Commissioner of Internal Revenue. No technical question of practice is involved; the sole question is whether or not the tax was wrongfully assessed and collected.

The tax in question amounted to \$20,208.94 and was paid as income tax for the year 1914. The plaintiff had received certain stock from the Yale & Towne Manufacturing Company, and the receipt of this stock was the sole basis for the tax. The question presented by the writ of error is whether that stock, which was denominated a "stock dividend" in the court below, constituted taxable income.

Briefly, the complaint alleged the following facts:

On January 1, 1913, The Yale & Towne Manufacturing Company, a Connecticut corporation, had a small amount of outstanding capital stock, and had accumulated a large surplus out of its earnings of many previous years (fol. 7). During the year 1913 the directors of the corporation voted to transfer a million and a half dollars from surplus account to capital stock account, and to apply the amount to the payment of an issue of 15,000 shares of new stock of the par value of \$100. a share, and to distribute this stock *pro rata* among the existing stockholders of record on December 26, 1913, the actual distribution to be made on

January 2, 1914 (fols. 8-13). The earnings so appropriated from the surplus account and applied to the payment of the new stock were all accumulated prior to January 1, 1913 (fols. 8, 14).

The plaintiff was a large holder of stock in the company and received 4,174½ shares of new stock (fol. 13). The defendant, acting under instructions from the Treasury Department, contended that the new stock so received by the plaintiff constituted taxable income, and levied a tax thereon on the theory that this stock was legally equivalent to a cash dividend at the rate of \$100. a share (fol. 15).

By the receipt of this new stock the plaintiff's share or interest in the assets of The Yale & Towne Manufacturing Company was not changed, but the transaction merely increased the number of shares or parts into which his interest was divided; the market value of the plaintiff's total number of shares remained substantially the same and unaffected by the issue of new shares; before the surplus was capitalized the stock was selling at a price of from \$175. to \$177. per share, and after it was capitalized by this increase of fifty per cent. in the number of outstanding shares the market price was from \$110. to \$130. a share. The complaint shows that the price of the stock fluctuated from day to day over a range of ten or fifteen points, so that it appears that the market value of plaintiff's interest remained unaffected by this transaction.

The rate of cash dividends paid on the stock was correspondingly decreased at the time of the readjust-

ment of the capitalization. Prior thereto each share of stock was receiving cash dividends at the rate of \$10. a year; after the 1st of January, 1914, the annual rate of dividend was reduced to \$7. a year per share.

The complaint alleges that the stock did not constitute taxable income under the Income Tax Law of October 3, 1913, and that no tax was due on it; and further that if the stock was included within the terms of the Act of Congress of October 3, 1913, the law was unconstitutional and in violation of Article I, Section 2, Clause 3, and of Article I, Section 9, Clause 4 of the Constitution of the United States (fol. 17), and not within the terms of the Sixteenth Amendment.

The District Court passed upon both questions,—the constitutionality of the Act, and its construction.

The special and peculiar circumstances involved in the case and requiring a speedy hearing of the cause are as follows:

The Income Tax Law of 1913 levied a tax upon "dividends" as being income. The Treasury Department (February 18, 1915—T. D. 2163) ruled that

"Stock dividends issued as a bona fide and permanent increase of the capital stock of corporations, etc., without intent to evade the imposition of the personal income tax, are held to represent capital; and are not subject therefore to the income tax as gains, profits and income in the hands of the stockholders."

In reliance upon this ruling numerous corporations declared stock dividends, and the ruling was in force at the time the plaintiff filed his return of income and paid the tax on income received in 1914. Later by Treasury Decision 2274 (December 22, 1915), the Treasury Department reversed its previous ruling and in the new ruling stated that:

"Stock dividends paid from the net earnings or the established surplus or undivided profits of corporations, joint stock companies, or associations, and insurance companies, are held to be the equivalent of cash and to constitute taxable income under the same conditions as cash dividends. T. D. 2163 of February 18, 1915, is hereby reversed, and all rulings or parts of rulings heretofore made which are in conflict herewith are hereby revoked."

The Collector, defendant-in-error, acting under this later decision of the Department, required the plaintiff in error to pay a tax of upwards of \$20,000, upon the theory and claim that the stock above referred to was income. Numerous other citizens have been required by the authorities to make similar payments, the authorities are now requiring payment of many others, and still others are under the threat of imminent notice from the authorities requiring immediate payment. The sums involved amount to a considerable number of million dollars, and the payments required, if not justified by law, form a considerable oppression of the citizens in question.

The questions involved and to be presented to the Court for its determination are these: the construction of the Constitution and the constitutionality of Section II of the Act of October 3, 1913. The case at bar concerns a direct tax which must be apportioned unless "stock dividends" are income under the Sixteenth Amendment of the Constitution. It is the contention of the plaintiff in error that a stock dividend is not income under a proper construction of the Sixteenth Amendment; that a stock dividend is not income to the stockholder receiving it but is a mere readjustment of the form of a capital obligation already owned (*Gibbons v. Mahon*, 136 U. S. 549).

Further, the stock dividend now in question arose wholly from earnings of the corporation prior to January 1, 1913, and whether or not a stock dividend is taxable as income the stock received by the plaintiff representing profits of his corporation earned prior to January 1, 1913, constituted capital and not income under the law of 1913.

These questions, directly affecting the administration of the revenue, are of grave importance, and we conceive it to be in the public interest that this case should be advanced.

CHARLES E. HUGHES,
GEORGE WELWOOD MURRAY,
CHARLES P. HOWLAND,
LOUIS H. PORTER,
Counsel for Plaintiff-in-Error.

Office Supreme Court, U. S.
1871, 1872

DEC 10 1917

JAMES D. MAHER,
CLERK.

No. 563.

IN THE
Supreme Court of the United States,
OCTOBER TERM, A. D. 1917.

HENRY R. TOWNE,

Plaintiff-in-Error,

against

MARK EISNER, COLLECTOR, ETC.,

Defendant-in-Error.

MEMORANDUM FOR PLAINTIFF-IN-ERROR IN
OPPOSITION TO MOTION TO DISMISS,
AND IN REPLY.

CHARLES E. HUGHES,
GEORGE WELWOOD MURRAY,
CHARLES P. HOWLAND,
LOUIS H. PORTER,

Counsel for Plaintiff-in-Error.



IN THE
Supreme Court of the United States,
October Term, A. D. 1917.
No. 563.

HENRY R. TOWNE,
PLAINTIFF-IN-ERROR,

VS.

MARK EISNER, COLLECTOR, ETC.,
DEFENDANT-IN-ERROR.

MEMORANDUM FOR PLAINTIFF-IN-ERROR IN OPPOSITION TO MOTION TO DISMISS, AND IN REPLY.

FIRST. The Motion to Dismiss.

We submit that the contentions of the Government upon this motion are wholly without merit.

(1) It is not sought to review the decision, whether by an administrative officer or by a court, of any question of fact as to the property involved, its origin or

quality. The question arises upon demurrer. The property consists of a stock interest based on the accumulated surplus of a corporation, all of this surplus having arisen and having been invested by the corporation in its business prior to January 1, 1913, that is, prior to the adoption of the Sixteenth Amendment.

The question is this: Does this stock interest constitute "income" within the meaning of the Sixteenth Amendment? Does the fact that the accumulated surplus, thus arising before, was capitalized after the adoption of the Amendment, and that certificates of stock were issued accordingly, bring the stock interest itself, as distinguished from the income that may be received thereon, within the terms of the Amendment?

It would seem to be plain that this question calls for a construction of the constitutional provision. The Sixteenth Amendment did not create a new *power* of taxation, but it permitted a *method* of taxation not available before in the case of the income of property taxed because of ownership. (*Pollock v. Farmers' Loan & Trust Co.*, 158 U. S. 601, 637; *Brushaber v. Union Pacific R. R. Co.*, 240 U. S. 1, 19.) This is the reason the Amendment was adopted; and, having been adopted, of course questions may arise as to its construction or application. This case presents such a question.

The change wrought by the Amendment related not to all property, but to '*incomes*', and the Amendment was obviously prospective in operation. Not past accumulations of property, but future '*incomes*', were

to be subject to the new rule. If the stock interest here in question is not 'income', and is taxed by a method which is not constitutionally authorized unless it is 'income', how can it be said that no constitutional question arises? It can be of no avail to the Government to say that it made no claim that the United States 'had power under the Constitution to tax capital directly without apportionment', if such a tax has actually been laid and sustained against objection to its constitutional validity. Of course, it may be assumed that all questions of fact with respect to the sort of property involved may be decided without involving the constitutional question. But when the facts are found or conceded, and the tax is sustained under the Act of Congress as applied to these facts, the question of the validity of the tax thus upheld still remains.

We presume that it will not be disputed that this tax on this stock interest could not have been laid without apportionment prior to the Sixteenth Amendment. Is this tax on this stock interest within the terms of that Amendment?

The question undoubtedly arises, and so far from its being a frivolous one, we confess that we are unable to see how the constitutionality of the tax as laid in this case can be sustained.

(2) The constitutional question was presented in the court below. It was presented in the complaint itself. The plaintiff set forth the facts of the case and

specifically challenged the constitutional validity of the Act as applied in the levy of the tax in question (Paragraph XVIII, p. 11, fols. 17, 18).

(3) The District Court considered the constitutional question and decided it. The court referred to it in its opinion upon the demurrer to the original complaint (p. 24, fol. 44), and in the opinion handed down upon the demurrer to the amended complaint (on which the present question arises), the court restated its conclusion as follows (p. 18, fol. 33):

“I have already considered the constitutional question in my opinion already rendered in this action and adopt the same as my opinion on the demurrer to the complaint as now amended.”

(4) The constitutional question thus raised and decided below, has not been decided by this court.

It was not presented in the *Brushaber* case (240 U. S. 1) or in the other cases decided about the same time. Of course, we are not discussing the general validity of the Act of October 3, 1913, as an Income Tax Act, and we are not raising any of the questions heretofore discussed or decided in this court with respect to the Act in its relation to incomes. We are dealing simply with the validity of this Act as construed and applied in sustaining the tax on this stock interest. (See *e. g. Snyder v. Bettman*, 190 U. S. 249, a case of direct review on error to the Circuit Court

where the general validity of the Succession Tax Act was not assailed, the Act having already been sustained in its general features, but it was contended that the Act was unconstitutional in its application to the succession in question.) Nothing is more familiar than that an Act may be valid in its general operation and yet invalid with respect to a particular application.

In the *Brushaber* case, the question as to retroactivity related to the period between March 1, 1913, and the time of the passage of the Act on October 3, 1913; that is, to the period between the adoption of the Amendment and the enactment of the Statute. As the court pointed out (240 U. S. p. 20):

"The date of the retroactivity did not extend beyond the time when the Amendment was operative."

The taxability either of so-called 'stock-dividends' in general, or of 'stock-dividends' based upon the capitalization of surplus which had been accumulated prior to the adoption of the Amendment was not there involved.

We invoke the familiar rule that when a substantial constitutional question has been duly raised, has been passed upon by the court below, and has not been previously decided by this court, the party asserting the invalidity under the Constitution of the action taken under the authority of an Act of Congress and sustained by the court below, is entitled to bring his cause to this court and have it heard and determined.

Whether we are right or wrong on the merits of the question, we submit that we are properly here. (*The Fair v. Kohler Die Co.*, 228 U. S. 22, 25; *Geneva Fur-niture Co. v. Karpen*, 238 U. S. 254, 258, 259.)

(5) The cases cited by the Government are inapposite. In *Arbuckle v. Blackburn*, 191 U. S. 405, the Ohio statute was not attacked upon the ground that the police regulation it contained relating to adulterated food was in violation of the Constitution, but it was attempted to base the constitutional objection upon a hypothetical decision of questions of fact with respect to the nature of a given article. As the court said:

"The suggested controversy was purely hypothetical and based the supposed constitutional objections on the contingency that, on issues of fact, it might be judicially determined that *Ariosa* came within the statute, which complainants denied."

In *Cosmopolitan Mining Co. v. Walsh*, 193 U. S. 460, the question related to the construction of the constitution and laws of the State of Colorado or the application of principles of general law. It related to service of process. It was not disputed that the Mining Company in question had its mines within the State, had appointed an agent upon whom service of process might be made and that there had been no direct revocation of such agency. It was not contended (p. 472) that the State of Colorado could not, consistently with the Federal Constitution, have provided for the service in

question, and it thus appeared that the sole question was as to what the law of Colorado was.

In *Sloan v. United States*, 193 U. S. 614, the rights depended upon the Indian Allotment Act of August 7, 1882 (22 Stat. 342) and the Indian treaties referred to as a basis for jurisdiction were not involved. The right to the allotment was based upon the Act of 1882, and the defense was also based upon that Act (*id.*, p. 620).

In *American Sugar Refining Co. v. United States*, 211 U. S. 155, certain regulations enacted by the Treasury Department were before the Court. It was found that undoubtedly Congress "without violating any constitutional provision" could have in terms directed "exactly what was prescribed by the Treasury regulations", and that "prior decisions have held that the statute was properly construed by the Secretary".

These cases, which it seems to us are clearly not in point, are those which the Government describes as 'the more significant' of the cases which it cites. Its other citations are simply cases stating the familiar principle that a substantial constitutional question must be involved.

The *Sloan* case and the case of the *American Sugar Refining Company v. United States*, cited above, were reviewed and explained in *B. Altman & Co. v. United States*, 224 U. S. 583, 599. In the *Altman* case, a bronze bust imported from France was assessed for duty at 45 per cent. as a composition of metal under the Tariff Act of 1897 (30 Stat. 151, 167), and the

Circuit Court had sustained the duty. The importer contended that the article was 'statuary' and assessable at 15 per cent. under the reciprocal commercial agreement with France. Section 3 of the Tariff Act of 1897 authorized such an agreement with respect to certain articles described in the Act, including "paintings in oil or water colors, pastels, pen and ink drawings, and *statuary*", and a reciprocal agreement was made with France (30 Stat. 1774) as to these articles. The question was whether the bust was 'statuary'. This was the word used in both the reciprocal agreement and in the Act which authorized it. Moreover, '*statuary*' was, as this Court pointed out, specifically defined in the Act, and the Court held that the reference in the reciprocal agreement was to 'statuary' as thus defined in the Act. But this Court overruled the contention of the Government that it was without jurisdiction, and held that the reciprocal agreement was a treaty, that its construction was involved, and that there was a right of review by direct appeal from the Circuit Court to this Court.

(5) The fact that the construction of a statute may also be involved does not affect the right of direct appeal to this Court if the question of the construction and application of the Federal Constitution, and of the validity of the statute as construed and applied has been duly raised. This principle has frequent illustration. With respect to the analogous case of a treaty, it is illustrated in the *Altman* case, *supra*. And as to

instances in which both statutory construction and the question of constitutional validity were involved we shall refer to but a few of the many decisions.

In *Spreckels Sugar Refining Co. v. McClain*, 192 U. S. 397, the case involved both the question of the construction of the Act and the question of its constitutional validity as there applied, and hence it was held that the plaintiff would have been entitled to bring the case directly to this Court, had he so elected (p. 407).

Southern Railway Company v. United States, 222 U. S. 20, was a case where the court took jurisdiction on direct writ of error to the District Court. The action was brought to recover penalties for the violation of the Safety Appliances Acts. Had it been held, on the question of construction of the statute, that the amendatory Act did not enlarge the original Act but, like it, was limited in its application to vehicles moving interstate traffic, there would have been no question of constitutional validity. But the court construed the amendatory Act as embracing vehicles used in moving intrastate traffic on a railroad which was a highway of interstate commerce, and hence it was brought to the question of the power of Congress thus to legislate. The jurisdiction of this court was not affected by the fact that had the amendatory Act been construed the other way (and the question of its construction was a very important one) there would have been no occasion to consider the question of constitutional power.

So, in *Lewis Publishing Co. v. Morgan*, 229 U. S. 288, the case came to this court on direct appeal as involving both the constitutionality and construction of the provisions in the Post Office Appropriation Act of 1912 in regard to the privileges of second class mail matter and the questions were resolved by a full consideration of the true interpretation of the statute.

In *Billings v. United States*, 232 U. S. 261, the question related to the construction as well as the constitutionality of section 37 of the Tariff Act of 1909 imposing a tax on the use of foreign built yachts. There, error had been prosecuted directly from this court to the Circuit Court by the defendant, and from the Circuit Court of Appeals by the United States. This Court held that "both writs of error, when taken, were authorized", and that on the direct writ of error, "the jurisdiction of this court was not confined to the constitutional questions" but embraced "every issue in the case". This court addressed itself to the construction of the statute and it was only after it had reached the conclusion that the use of the vessel was within the provision of the statute that it considered the question of power. The court said (p. 282):

"As under the meaning which we thus give the statute the admitted use of the vessel was within its provision and therefore the amount due for excise was rightfully imposed and under our interpretation was due when demanded, we must consider whether the asserted repugnancy

of the statute to the Constitution is well founded".

See also,

Rider v. U. S., 178 U. S. 251, 260;

Cornell v. Coyne, 192 U. S. 418, 430, 431.

Choctaw, Oklahoma & Gulf R. R. Co. v. Harrison, 235 U. S. 292.

Again, where a question is presented as to the impairment of the obligation of contract in violation of the Federal Constitution, the case is not taken out of the jurisdiction of this Court to review the decision on direct appeal from the District Court (or the old Circuit Court) because of the contention by the opposing party that the contract according to its true construction does not give the right which it is contended has been taken away.

Vicksburg v. Water Works Co., 202 U. S. 453, 458, 459.

It is generally the case, where the application of the Federal Constitution is involved, and the question arises under a statute which has been construed so as to affect the interest of the complaining party, that there is presented the question as to the true meaning of the statute and, of course, if it is so construed as not to hit the plaintiff's case, it is not necessary to decide the constitutional question; but if the statute is otherwise construed the constitutional question is unescapable. Its presence in the case gives the Court

jurisdiction on direct appeal. Having jurisdiction all questions in the case are before the Court.

Penn Mutual Life Insurance Co. v. Austin,
168 U. S. 685, 695, 696;

Burton v. U. S., 196 U. S. 283, 285;

Siler v. Louisville & Nashville R. R. Co., 213
U. S. 174, 191.

Boise Water Co. v. Boise City, 230 U. S. 84;

Greene v. Louisville & Interurban R. R. Co.,
244 U. S. 499, 519.

If the contention of the Government were correct, no constitutional question could arise as to what is 'income' under the Sixteenth Amendment, and Congress may tax whatever property it likes, without apportionment. That would be the result of holding the question to be simply one of statutory construction. But the Sixteenth Amendment, like any other provision of the Constitution, is to be construed and applied. This does not mean that cases already decided are to be reargued or that frivolous contentions are to be entertained. We have here a new question and a very important one. Whether a stock interest based on accumulations antedating the adoption of the Sixteenth Amendment is to be treated as 'income' and, as such, subject to the method of taxation permitted by that amendment, is a substantial question upon which we are entitled, as we submit, to the decision of this court. As was said by this court in *Choctaw*,

Oklahoma & Gulf R. R. Co. v. Harrison, *supra*, repeating what had been said in the *Galveston* case:

"Neither state courts not legislatures, by giving a tax a particular name, or by the use of some form of words, can take away our duty to consider its real nature and effect. (*Galveston, Harrisburg & San Antonio Ry. v. Texas*, 210 U. S. 217, 227)."

The same is true of a Federal Tax Act.

SECOND. The Merits.

Upon the merits we have only a brief word, as we think the points raised by the Government are fully met in our principal brief. Its answers do not seem to us to be answers.

The difficulty of its position in endeavoring to maintain a tax of this sort is shown in what it finds it necessary to present as a definition of 'income' in giving the Government's view of the construction of the Act. The Government says that "'Income' represents the advantage, service or use actually rendered by 'capital' to its owner during a period of time". Such a definition leads one quite afar. Thus a very important 'service' or 'advantage' of capital, which every business man would be swift to recognize, is the advantage or service that it gives in enabling him to have a line of credit at his bank. He gives his bank a statement of his resources and he is allowed a line of credit "during a period of time". If, at the end of

this 'period' he is able to make good his obligations but has no gain, it would strike him as extraordinary to say that this line of credit constituted 'income' on which he should pay a round sum to the Government through an income tax. Perhaps, following the analogy of the present case, if a man had a line of credit for a year of \$100,000 he should pay an income tax upon this 'advantage' or 'service' of his capital as amounting to \$100,000. It would hardly be a more remarkable result than the taxation in this case of \$1,500,000 of the increased stock of the Yale & Towne Manufacturing Company based on accumulations antedating January 1, 1913, as constituting 'income' accruing after March 1, 1913.

A better definition, which embraces the essential element of 'gain', is found in *Stratton's Independence v. Howbert*, 231 U. S. 399, 415, where it is said:

"'Income' may be defined as the gain derived from capital, from labor, or from both combined."

Or, it may be said, quoting the language of Professor Seligman:

"Strictly speaking, income as contrasted with capital denotes that amount of wealth which flows in during a definite period and which is at the disposal of the owner for the purposes of consumption, so that in consuming it, his capital remains unimpaired." (Seligman on Income Tax, p. 20.)

Of course it is not denied that income may be in the form of property, although it is well settled that in construing an Income Tax Act income is taken to mean money in the absence of any special provision of law to the contrary, and not the mere expectation of receiving it (*United States v. Schillinger*, 14 Blatch. 71). If, however, the Act reaches property and not simply money, it must still be property that constitutes 'gain' or, 'income'. It is not 'income' simply because it is property.

It is urged that this Company would not have increased its capital stock if there had not been advantages of a business nature. Of course there are advantages of a business nature, but these do not necessarily constitute 'income'. The advantages were set out in the report to the Board of Directors (fols. 20-30). Suppose there was a practical business advantage in having a larger number of shares, and thus making the shares available in the market at a smaller premium, it would not follow that this advantage constituted 'income'. And upon what theory would such an advantage, even if it could be treated as income permit a tax on the value of the entire share representing the interest in the assets as they existed before January 1, 1913? There may be business advantages which appeal to men taking a far-sighted view of their business arrangements, which are not even reflected in the market by any difference in market quotations. Thus, in the present case the issue of the new stock

which had the effect of diluting the old stock and increasing the number of shares did not change appreciably the market value of the whole; for the former market value of the shares reflected the surplus which was the basis for the new issue.

Again it is urged that there are new rights, but what are these '*rights*', and do they constitute '*income*'? We have discussed fully these new rights in our principal brief (pp. 43-51) and we shall not repeat the argument, which it seems to us has not been answered. The '*new right*' in substance, so far as it relates to income, is the right to get dividends on this capitalized amount.

We may add another illustration. Suppose corporation A has a capital stock of \$1,000,000 and net assets of like amount. Suppose for good reasons of business advantage, perhaps because of a general apprehension with respect to some infirmity in organization or a desire to have the general benefit of a new charter, corporation A sells its assets to corporation B, then organized, and corporation B issues its stock of \$1,000,000 therefor, having no other property. Corporation A then dissolves and its stockholders exchange their stock for like shares of corporation B. Here are new rights, perhaps very important. Here are substantial business reasons, satisfactory to the parties. Most likely the market, taking account of dollars and cents, has the same valuation for both the old and the new shares. Is the \$1,000,000 of the stock of corporation

B taxable against the stockholders as constituting 'income'?

Suppose, to give the stockholder a 'muniment of title' corporation B had issued stock when no par value and the rest of the transaction had been the same, would the stock have been taxable as 'income'?

Mere general availability or advantage not susceptible of measurement as a pecuniary gain is not to be considered 'income'. Here there is nothing susceptible of pecuniary measurement except the interest in the assets which was possessed before January 1, 1913. The market value is practically the same.

With respect to the authorities, we add merely a word to what we have already said. In discussing the case of *Bailey v. Railroad Co.*, 22 Wall. 604 (see Government's brief, p. 24), the Government takes the position which was taken in *dissent* in *United States v. Erie Ry. Co.*, 106 U. S. 327, 331. But the court expressly followed the rule which had been announced by Mr. Justice Miller as the conclusion of the court in *Railroad Company v. Collector*, 100 U. S. 595, 598. We have referred sufficiently in our principal brief to the rulings under the Act of 1864. It is obvious that the question raised and decided in the *Pollock* case was not in the mind of the court, and, further, the tax in the *Bailey* case was finally and authoritatively adjudged to be an excise tax on the business of the corporation. As was said in the *Brushaber* case (240 U. S. p. 19), the Sixteenth Amendment at least im-

pliedly makes the 'wider significance' of the words 'direct tax' as adjudged in the *Pollock* case 'a part of the Constitution',—a condition, as was said "which clearly demonstrates that the purpose was not to change the existing interpretation except to the extent necessary to accomplish the result intended".

With respect to *Logan County v. United States*, 169 U. S. 255, it is sufficient to quote the following from the opinion of the court (p. 261):

"But no distribution could take place by any stock dividend. Such a dividend distributed nothing but stock, which made the stockholder neither richer nor poorer than he was before it was issued."

If it be assumed, as the Government argues, that the question is an open one, we return to the consideration of the essential nature of the stock dividend and we think that a consideration of this will suffice to show that a stock dividend based on the accumulations antedating January 1, 1913, was neither within the Act of 1913 nor within the Amendment.

We submit that this question should be decided as the Treasury Department first decided it when it held that such stock dividends were not taxable under the Act of 1913 because the interest was a capital interest and not 'income'. We submit that it should be decided as it was decided by Congress in the Act of 1916, when, undertaking to tax stock dividends, it expressly

provided that this should not apply to those based on surplus antedating March 1, 1913.

The Government says that "capital represents the wealth or property of a person at a given instant of time". All capital necessarily embraces both accretions of capital and accumulations of income. But it will not do to say that accumulations of income continue to remain income. On this view, the colonist who immigrated to this country before the Revolution and invested his savings of income in a piece of real estate had merely an income interest and his descendants continue to hold an interest not capital, but income, and thus a direct tax could be levied upon the real estate without apportionment. The truth of the matter is put in the Government's statement that capital represents the wealth or property of a person 'at a given instant of time'. The instant of time in the present case is March 1, 1913.

We recur again to the conceded and unescapeable fact. The corporation on March 1, 1913, had certain assets invested in its business. The stock of the plaintiff-in-error represented his interest in these aggregate assets. The subsequent capitalization of the surplus did not add to his interest. It destroyed the possibility of paying the surplus out in dividends. The stockholder has had no gain. The question, of course, is not as to any income which he may receive in the future upon this interest. But he is now taxed prac-

tically upon one-third of the interest in the aggregate assets which he held on March 1, 1913, that is upon one-third of his entire capital. He is taxed for the full or capital value of this interest. We submit that the tax cannot be sustained.

Respectfully submitted,

CHARLES E. HUGHES,
GEORGE WELWOOD MURRAY,
CHARLES P. HOWLAND,
LOUIS H. PORTER,
Counsel for Plaintiff-in-Error.

17
No. 563.

FILED
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IN THE
Supreme Court of the United States,
OCTOBER TERM, A. D. 1917.

HENRY R. TOWNE,
Plaintiff-in-Error,
against

MARK EISNER, COLLECTOR, ETC.,
Defendant-in-Error.

IN ERROR TO THE DISTRICT COURT OF THE UNITED STATES FOR THE
SOUTHERN DISTRICT OF NEW YORK.

BRIEF AND ARGUMENT FOR PLAINTIFF-
IN-ERROR.

CHARLES E. HUGHES,
GEORGE WELWOOD MURRAY,
CHARLES P. HOWLAND,
LOUIS H. PORTER.
Counsel for Plaintiff-in-Error.



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IN THE
Supreme Court of the United States,
October Term, A. D. 1917.

No. 563.

HENRY R. TOWNE,
PLAINTIFF-IN-ERROR,

AGAINST

MARK EISNER, COLLECTOR OF UNITED STATES IN-
TERNAL REVENUE FOR THE THIRD DISTRICT OF THE
STATE OF NEW YORK,
DEFENDANT-IN-ERROR.

IN ERROR TO THE DISTRICT COURT OF THE UNITED STATES FOR
THE SOUTHERN DISTRICT OF NEW YORK.

STATEMENT OF THE CASE.

This is a writ of error to review the final judgment of the United States District Court for the Southern District of New York, entered upon an order sustaining the defendant's demurrer to the plaintiff's second amended complaint.

The action was brought to recover a tax assessed under the Income Tax Law of 1913 on the ground that it was illegally assessed. The plaintiff paid the tax under protest and took an appeal in due time to the Commissioner of Internal Revenue, and more than six months elapsed from the time of taking the appeal before the commencement of this action. There is no technical question of practice involved. The sole question is whether or not the tax was wrongfully assessed and collected.

The applicable portions of the Tariff Act, Section II of October 3, 1913 (38 Stat. 166), are printed in the margin.¹

¹"A. Sub-division 1. That there shall be levied, assessed, collected, and paid annually upon the entire net income arising or accruing from all sources in the preceding calendar year . . . a tax of 1 per centum per annum upon such income except as hereinafter provided; . . .

Sub-division 2. In addition to the income tax provided under this section (herein referred to as the Normal Income Tax), there shall be levied, assessed, and collected upon the net income of every individual an additional income tax (herein referred to as the Additional Tax) of 1 per centum per annum upon the amount by which the total net income exceeds \$20,000; . . .

B. That, subject only to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shall include gains, profits, and income derived from salaries, wages, or compensation for personal services of whatever kind and in whatever form paid, or from professions, vocations, businesses, trade, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use or interest in real or personal property, also from interest, rent, dividends, securities, or the transaction of any lawful business carried on for gain or profit, or gains or profits and income derived from any source whatever, including the income from but not the value of property acquired by gift, bequest, devise, or descent; . . .

That in computing net income for the purpose of the normal tax there shall be allowed as deductions: . . . seventh, the amount received as dividends upon the stock or from the net earnings of any corporation, joint stock company, association, or insurance company which is taxable upon its net income as hereinafter provided."

The action was brought for the recovery of \$20,-208.94 paid by the plaintiff to the defendant under protest as income tax for the year 1914. This amount was assessed and collected upon certain stock received by the plaintiff from The Yale & Towne Manufacturing Company. The question presented by this writ of error is whether that stock, which was denominated a "stock dividend" in the Court below, constituted income taxable under the Sixteenth Amendment of the Federal Constitution and the Income Tax provisions of the Act of 1913. Briefly the complaint alleges the following facts:

On January 1, 1913 (prior to the adoption of the Sixteenth Amendment), The Yale & Towne Manufacturing Company, a Connecticut corporation, had outstanding capital stock of \$2,000,000 divided into 20,000 shares of the par value of \$100 each, and had accumulated a large surplus out of its earnings of many years. This surplus was invested by the Company in its business, being represented by plant and working capital (fols. 8, 11). The capital stock was later increased by the addition of 10,000 shares, for which \$1,000,000 was subscribed and paid in cash (fol. 9), thus making a total of 30,000 shares. During the fall of 1913 the directors of the corporation voted to transfer \$1,500,000 from surplus account to capital stock account by the increase of the capital stock in that amount and the issue to the stockholders of 15,000 additional shares of the par value of \$100 each, and this action was taken (fols.

9-13). The earnings and surplus represented by this stock issue were all accumulated and invested in the business prior to January 1, 1913 (fols. 8, 15).

The plaintiff was a large holder of stock in the Company and received 4,174½ shares of this issue (fol. 13). The defendant, acting under instructions from the Treasury Department, contended that the stock so received by the plaintiff constituted taxable income, and levied a tax thereon on the theory that this stock was legally equivalent to a cash dividend at the rate of \$100. a share (fol. 15).

By the receipt of this new stock the plaintiff's share or interest in the plant and property of The Yale & Towne Manufacturing Company was not changed, but the transaction merely increased the number of shares or parts into which his interest was divided; the market value of the plaintiff's total number of shares remained substantially the same and unaffected by the issue of new shares; before the surplus was capitalized the stock was selling at a price of from \$175. to \$177. per share, and after it was capitalized by this increase of fifty per cent. in the number of outstanding shares the market price was from \$110. to \$130. a share. The complaint shows that the price of the stock fluctuated over a range of ten or fifteen points, so that it appears that the market value of plaintiff's interest remained unaffected by this transaction.

The rate of cash dividends paid on the stock was correspondingly decreased at the time of the readjustment of capitalization. The amount of dividends re-

ceived by each stockholder on all his shares, including the additional shares, remained substantially the same as it had been before the capital was readjusted (fols. 13, 14).

The complaint alleges that the stock did not constitute taxable income under the Income Tax Law of October 3, 1913, and that no tax was due on it; and further that if the stock was included within the terms of the Act of Congress of October 3, 1913, the law as thus applied was unconstitutional and in violation of Article I, Section 2, Clause 3, and of Article I, Section 9, Clause 4 of the Constitution of the United States (fol. 17), and not authorized by the Sixteenth Amendment.

The District Court sustained the constitutional validity of the Act, construed as applying to the stock in question, and rendered final judgment against the plaintiff (Opinion, fol. 33; Judgment, fols. 3, 4).

SPECIFICATION OF ERRORS.

I. The Court erred in holding that the tax alleged in the complaint was not a violation of Article I, Section 9 of the Constitution of the United States as a direct tax on capital not laid in proportion to the census or enumeration therein mentioned (fols. 47, 48).

II. The Court erred in holding that the tax alleged in the complaint was not a violation of Article I, Sec-

tion 2 of the Constitution of the United States as a direct tax not apportioned among the several states.

III. The Court erred in holding that the tax alleged in the complaint was a tax on income within the meaning of the Sixteenth Amendment to the Constitution of the United States.

IV. The Court erred in holding that the tax alleged in the complaint was a tax on income within the meaning of the Income Tax Law of October 3, 1913.

V. The Court erred in holding that a stock dividend constituted taxable income.

VI. The Court erred in holding that the shares of stock received by the plaintiff on the readjustment of the capitalization of The Yale & Towne Manufacturing Company were a stock dividend.

VII. The Court erred in holding that stock distributed to stockholders of corporations, representing the capitalization of profits earned prior to March 1, 1913, was taxable as income.

VIII. The Court erred in holding that profits of a corporation earned prior to March 1, 1913, constituted taxable income to the individual stockholders if distributed to them by the corporation subsequent to that date (fols. 47, 48).

SUMMARY OF POINTS.

I.

THE CONSTITUTIONALITY OF SECTION II OF THE ACT OF OCTOBER 3, 1913, CONSTRUED TO BE APPLICABLE TO THE PLAINTIFF'S STOCK, IS DRAWN IN QUESTION.

1. Before the Sixteenth Amendment there were two kinds of income, subject to different constitutional rules as to taxability, viz.: p. 13

- a. Gains and profits from "business, privileges, employments and vocations". These were subject to excise taxes. p. 13

Pollock v. Farmers Loan & Trust Co., 158 U. S. 601, 637.

Flint v. Stone Tracy Co., 220 U. S. 107.

Stratton's Independence, Ltd. v. Howbert, 231 U. S. 399.

Stanton v. Baltic Mining Co., 240 U. S. 103, 114.

- b. Income from real or personal property, as such. Taxes on real or personal property, and on the income derived therefrom, because of its ownership, were held to be direct taxes, requiring apportionment among the states according to population. p. 14

Pollock v. Farmers Loan & Trust Co., 158 U. S. 601, 637.

Brushaber v. Union Pacific R. R. Co., 240 U. S. 1.

2. The tax in controversy is laid directly upon the property in question, as such, because of its ownership. Investments in stock are unquestionably within the rule of the *Pollock* case (158 U. S. 601, 637). pp. 14, 15, 19

3. The case at bar, therefore, concerns a direct tax which must be apportioned unless the stock in question constitutes income under the Sixteenth Amendment. pp. 14-20
Constitution of the United States, Art. 1,
Secs. 2 and 9; Sixteenth Amendment.

II.

THE STOCK IN QUESTION IS NOT INCOME WITHIN THE MEANING OF THE SIXTEENTH AMENDMENT.

1. A 'stock dividend' is not income to the stockholder receiving it, but is a mere readjustment of the evidence of the stockholder's interest already owned. The 'stock dividend' takes nothing from the property of the corporation and adds nothing to the interests of the stockholders. The only change in substance is that, instead of the property represented thereby being distributed to stockholders, it is permanently fixed as capital so that it cannot be distributed. pp. 21-37

Gibbons v. Mahon, 136 U. S. 549.

Bouch v. Sproule, 12 App. Cass. 385.

Jones v. Evans (1913), 1 Ch. 23.

In re Carson, Irish Reports (1915), Vol I, p. 321.

Guinness, Trustee v. Guinness, Cas. Ct. Session, 5th Ser., Vol. 6, p. 104.

Minot v. Paine, 99 Mass. 101.

Davis v. Jackson, 152 Mass. 58.

D'Ooge v. Leeds, 176 Mass. 558.

Hyde v. Holmes, 198 Mass. 287.

Gray v. Hemenway, 212 Mass. 239.

Terry v. Eagle Lock Co., 47 Conn. 141.
Brinley v. Grau, 50 Conn. 66.
Spooner v. Phillips, 62 Conn. 62.
Green v. Bissell, 79 Conn. 547.
DeKoven v. Alsop, 205 Ill. 309.
Billings v. Warren, 216 Ill. 281.
Kaufman v. Charlottesville Mills Co., 93 Va.
 673.
Williams v. Western Union Tel. Co., 93 N. Y.
 162, 189.
Brown v. Larned, 14 R. I. 371, 373.
Lancaster Trust Co. v. Mason, 152 N. C. 660.
Great Western Mining & Mfg. Co. v. Harris,
 128 Fed. 321, 326.

2. The stock in question was based on earnings which had been accumulated by the corporation prior to January 1, 1913, that is, prior to the adoption of the Sixteenth Amendment, and neither this stock nor the accumulated surplus which it represented was subject to taxation without apportionment as being income within the meaning of that Amendment. pp. 38-52

Shreveport v. Cole, 129 U. S. 36, 43.
Brushaber v. Union Pacific R. R. Co., 240
 U. S. 1, 20.
Matter of Osborne, 209 N. Y. 450.
Earp's Appeal, 28 Pa. St. 368.
Lang v. Lang's Executor, 57 N. J. Eq. 325.

Day v. Faulks, 79 N. J. Eq. 66; 81 *id.* 173.
Will of Pabst, 146 Wisc. 330, 340.
Holbrook v. Holbrook, 74 N. H. 201.
Thomas v. Gregg, 78 Md. 545, 560.
Prichard v. Nashville Trust Co., 96 Tenn.
 472.
Thompson on Corporations, Sec. 5414.
Cook on Corporations (7th ed.) sec. 554
et seq.

III.

IT WAS NOT THE INTENTION OF CONGRESS IN THE ACT OF OCTOBER 3, 1913, TO TAX 'STOCK DIVIDENDS' AND CERTAINLY NOT TO TAX 'STOCK DIVIDENDS' BASED ON SURPLUS ACCUMULATIONS EXISTING PRIOR TO JANUARY 1, 1913. UNDER A PROPER CONSTRUCTION OF THE STATUTE THE TAX ON THE STOCK IN QUESTION WAS NOT JUSTIFIED.

1. "Income" in an income tax law, unless it is otherwise specified, means cash or its equivalent. It does not mean choses in action or unrealized increments in the value of property. p. 52

U. S. v. Schillinger, 14 Blatch. 71.
Gray v. Darlington, 15 Wallace, 63, 66.
Baldwin Locomotive Works v. McCoach,
 221 Fed. 59.

2. The stock in question was not a "dividend" within the meaning of the word "dividends" used in the Act of 1913. If Congress had intended to embrace 'stock dividends' based on surplus accumulations capitalized Congress would have said so. p. 55

Hyatt v. Allen, 56 N. Y. 553, 556.

Gibbons v. Mahon, 136 U. S. 549, 569.

Income Tax Law of 1913, Sec. II, Sub. 2-B, 389 Stat. 166. (See Appendix.)

3. The tax for which the Act of 1913 provides is an annual tax upon the entire net income arising or accruing in the preceding calendar year. For the year 1913 the tax was to be computed on the net income accruing after March first. p. 60

Income Tax Law of 1913, Sec. II, A, sub-div-2, D., 38 Stat. 168. (See Appendix.)

Gray v. Darlington, 15 Wallace, 63.

Merchants' Insurance Co. v. McCartney, 1 Lowell, 447.

Bailey v. Railroad Company, 106 U. S. 109.

People v. Albany Insurance Co., 92 N. Y. 458, 462.

Gauley Mt. Coal Co. v. Hays (C. C. A., Fourth Circuit), 230 Fed. 110.

Doyle v. Mitchell (C. C. A., Sixth Circuit), 235 Fed. 686.

C. & C. C. St. L. Ry. Co. v. U. S. (C. C. A., Sixth Circuit), 242 Fed. 18.

Lynch v. Turrish (C. C. A., Eighth Circuit), 236 Fed. 653.

4. When Congress undertook to tax 'stock dividends' it provided for the tax in express terms and excluded 'stock dividends' based on surplus accumulations existing prior to March 1, 1913. p. 74

Act of September 8, 1916, 39 Statute 756,
Sarlls v. U. S., 152 U. S. 570, 577.

Matthews v. McStea, 91 U. S. 7, 13.

Matter of Miller, 110 N. Y. 216, 222.

Endlich, on Interpretation of Statutes, Secs.
 43, 44, 47.

War Revenue Act of Oct. 3, 1917, Sec. 1211,
 adding to Income Tax Law Sec. 31. (See
 Appendix.)

ARGUMENT.**I.****THE CONSTITUTIONALITY OF THE TAX COMPLAINED
OF IS DRAWN IN QUESTION.**

The question of the constitutional validity of the Act of 1913, as construed to authorize the tax on the stock in question, was distinctly raised in the complaint (fols. 17, 18) and was passed upon by the District Court (fols. 33, 44). As the construction of the Constitution, and the constitutionality of the law were thus drawn in question, the case properly comes here on direct appeal (Judicial Code, Sec. 238). The question is as to the meaning of the term "income" as it is used in the Sixteenth Amendment.

Before the Sixteenth Amendment, there were two kinds of income with respect to taxability under the Federal Constitution.

(a) Gains and profits from "business, privileges, employments, and vocations" whether of corporations or of individuals.

Pollock v. Farmers Loan & Trust Co., 158
U. S. 601, 637.

A tax upon such gains and profits was an excise subject to the constitutional requirement as to geographical uniformity.

Pollock v. Farmers Loan & Trust Co., 158 U. S. 601, 635.

Brushaber v. Union Pacific R. R. Co., 240 U. S. 1.

Stanton v. Baltic Mining Co., 240 U. S. 103.

The Corporation Tax Act of 1909 fell within this category.

Flint v. Stone Tracy Co., 220 U. S. 107.

Stratton's Independence, Ltd. v. Howbert, 231, 399.

(b) Income from real or personal property, as such, taxed by reason of ownership.

A tax upon such income is not an excise, but a direct tax. The question involved in the *Pollock* case related to this sort of income, and it was held that as the tax was a direct tax Congress had no constitutional power to impose it without the required apportionment among the States according to population (Const. Art. I, Secs. 2 and 9).

In the case at bar we are concerned solely with this direct tax; not at all with the excise tax referred to in most of the cases relied upon by the Government below.

"Direct taxes", which are within the restriction of

Article I, Secs. 2 and 9, include not only capitation taxes and taxes upon lands, houses, and other real property, but also all taxes on personal property or investments, including income from either real or personal property, taxed because of ownership.¹ Taxes on investments in corporate stocks, laid directly because of ownership, are in this class.

Pollock v. Farmers' Loan & Trust Co., 158 U. S. 601, 637.

The Sixteenth Amendment removed the requirement of apportionment only in the case of taxes on incomes. It provides:

"The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

The history of this Amendment is well known. It was adopted for the purpose of avoiding the effect of the decision in the *Pollock* case, and of permitting Congress to levy a tax on incomes without apportionment. Taxes on "income" from whatever source derived were thus placed in the same category and could be levied without apportionment, being subject in the same manner as excises to the constitutional requirement as

¹The Court said in the *Brushaber* case, reviewing the decision in the *Pollock* case (240 U. S., p. 16).

"the classification of direct was adopted for the purpose of rendering it impossible to burden by taxation accumulations of property, real or personal, except subject to the regulation of apportionment, . . ."

to geographical uniformity (*Brushaber v. Union Pacific R. R. Co.*, 240 U. S., pp. 18, 19).

The question remains, What is "income"?

There is nothing in the Sixteenth Amendment which authorizes Congress to levy, without apportionment, a tax on anything which does not come within the proper definition of "income". It was, obviously, not the intention to authorize Congress to levy a direct tax on property, except as to income, or otherwise amend to qualify, or in any way restrict the requirements which have existed ever since our Constitution was adopted, that direct taxes on property can be levied by Congress only if properly apportioned among the States.

In some of the five cases involving questions under the Income Tax Section of the 1913 Tariff Law, reported in 240 U. S., the limitations of Article I, Sections 2 and 9, of the Constitution, requiring that direct taxes be apportioned, were urged as restricting certain operations of the law with respect to the facts in the cases before the Court, and this Court sustained the law as against the contentions there urged. In none of them, however, was the present question presented.

In *Stanton v. Baltic Mining Co.*, 240 U. S. 103, the question related to the tax on mining corporations, and it was found that the tax there under consideration was not "a tax upon property as such, because of its ownership", but like the tax considered in *Stratton's Independence, Ltd. v. Howbert*, *supra*, was "a true excise", levied on the results of the business of the corporation

"in carrying on mining operations". An attempt was made by the Government in the court below to sustain its position by reference to the case of *Von Baumbach v. Sargent Land Co.*, 242 U. S. 503. But this was the case of an excise tax under the Corporation Tax Act of 1909. There was not involved in either of these cases any tax against the stockholder upon his investment as such.

That any attempt under the guise of an income tax law to levy an unapportioned direct tax on real or personal property could not be sustained is evident from the statements in the opinion of the Court delivered by Mr. Chief Justice White in the *Brushaber* case.¹ The

¹In the *Brushaber* case (*supra*) Mr. Chief Justice White, speaking for the Court said (pp. 18, 19) "the whole purpose of the amendment was to relieve all income taxes when imposed from apportionment from a consideration of the source whence the income was derived. . . . it was drawn with the object of maintaining the limitations of the constitution and harmonizing their operation. We say this because it is to be observed that although from the date of the *Hylton* case because of statements made in the opinions in that case it had come to be accepted that direct taxes in the constitutional sense were confined to taxes levied directly on real estate because of its ownership, the Amendment contains nothing repudiating or challenging the ruling in the *Pollock* case that the word direct had a broader significance since it embraced also taxes levied directly on personal property because of its ownership, and therefore the amendment at least impliedly makes such wider significance a part of the Constitution—a condition which clearly demonstrates that the purpose was not to change the existing interpretation except to the extent necessary to accomplish the result intended, that is, the prevention of the resort to the sources from which a taxed income was derived in order to cause a direct tax on the income to be a direct tax on the source itself and thereby to take an income tax out of the class of excises, duties, and imposts and place it in the class of direct taxes."

Again, in *Stanton v. Baltic Min. Co.*, (*supra*), Mr. Chief Justice White said (p. 113):

"We are here dealing solely with the restriction imposed by the Sixteenth Amendment on the right to resort to the source whence an income is derived in a case where there is power to tax for the purpose of taking the income tax out of the class of indirect to which it generically belongs and putting it in the class of direct to which it would not otherwise belong in order to subject it to the regulation of apportionment."

doctrine of the *Pollock* case remains the law of the land, except so far as a tax on "income" has been removed through the Constitutional Amendment from the application of that doctrine.

It is also apparent that there was no intention to authorize Congress or the Treasury Department of the United States to coin at will definitions of "income" and prescribe that something which is not, in any true sense of the word, income shall be income for the purposes of taxation. Congress cannot by legislative fiat put a subject of a tax in a different category from that in which it properly belongs, for that would be to subject the Constitutional restrictions to the legislative will.

What constitutes income is exclusively a matter for determination by the Court.

The Treasury Department originally held (T. D. 2163, February 18, 1915) that:

"Stock dividends issued as a *bona fide* and permanent increase of the capital stock of corporations, etc., without intent to evade the imposition of the personal income tax, are held to represent capital; and are not subject therefore to the income tax as gains, profits and income in the hands of the stockholders."

In reliance upon this ruling numerous corporations declared stock dividends and the ruling was in force

at the time the plaintiff filed his return of income and paid the tax on income received in 1914.

Later the Treasury Department reversed its ruling by Treasury Decision 2274 (December 22, 1915) stating:

“Stock dividends paid from the net earnings or the established surplus or undivided profits of corporations, joint stock companies, or associations, and insurance companies, are held to be the equivalent of cash and to constitute taxable income under the same conditions as cash dividends. T. D. 2163 of February 18, 1915, is hereby reversed, and all rulings or parts of rulings heretofore made which are in conflict herewith are hereby revoked.”

The fact that the Treasury Department under the Act of 1913 changed its ruling and held that a stock dividend should be considered income, does not, of course, settle the question. The judiciary “is the final authority in the construction of the Constitution and the laws”¹.

In the present case there is no room for disputing the fact that the tax is levied upon property solely by virtue of its ownership. The Yale & Towne Manufacturing Company had paid its excise tax under the Corporation Tax Act of 1909, and all the surplus in question was accumulated prior to January 1, 1913. There

¹Cooley, Const. Laws, 3d ed., p. 158.

is no pretense here that the present tax is laid upon the corporation, or by reason of any privilege or business of the corporation. The tax is levied upon the stock in question, simply because of the stockholder's ownership. The tax upon the stock by virtue of the stockholder's ownership, is, in the very nature of things, a direct tax which must be apportioned unless it can be said that this stock, issued in the circumstances we have stated, is income within the meaning of the Sixteenth Amendment. It is our contention that it is not.

II.

THE STOCK IN QUESTION IS NOT INCOME WITHIN THE MEANING OF THE SIXTEENTH AMENDMENT.

1. A 'stock dividend' is not income to the stockholder receiving it, but is a mere readjustment of the evidence of the stockholder's interest already owned. The 'stock dividend' takes nothing from the property of the corporation and adds nothing to the interests of the stockholders. The only change in substance is that, instead of the property represented thereby being distributed to stockholders, it is permanently fixed as capital so that it cannot be distributed.

The situation here presented is a typical one and the facts to which the question is addressed are familiar.

A corporation is not bound to distribute all its earnings in dividends. The directors may properly decide to use a portion of the earnings for the development of business, for the extension of plant, for betterments and for working capital. The undivided surplus of a corporation is not, normally, idle money; it is, normally, invested money. It is money invested in property, or embarked in the corporate enterprise; that is the reason it is not paid out in dividends. If the directors have not transcended the broad limits of their judgment, the stockholders cannot complain because earnings are invested instead of being distributed.

The interest of the stockholders, with respect to the property of the corporation, is an interest in the aggregate assets of the company, subject to the payment

of debts. It is not an interest in a segregated portion representing the original subscriptions; it is not an interest limited to an amount equal to the par value of their shares; it is not an interest limited to any particular portion of the corporate property, in the absence of special charter provisions, but is simply an interest in all the corporate assets. When these assets are swelled by the addition of undivided profits, the interest of the stockholders in these accumulations is precisely the same as their interest in any other property of the corporation. "The property of every company may consist of three separate distinct things, which are its capital stock, its surplus, its franchise. But these three things, several in the ownership of the company, are united in the ownership of the shareholders. The share stock covers, embraces, represents all three in their totality, for it is a business photograph of all the corporate possessions and possibilities" (*People ex rel U. T. Co. v. Coleman*, 126 N. Y. 433, 438).

When dividends are declared the amounts of the dividends are separated from the corporate property and are received by the stockholders respectively as their separate property. But until dividends separating money or property from the corporate assets in this way are declared, the stockholders continue to retain the interest in all these assets represented by their stock, the extent and value of their aggregate interests depending not upon the sums originally contributed to capital, but upon the extent and value of all the assets

of the corporation, including its accumulations, after deducting liabilities. When a so-called 'stock dividend' is declared, the company does not distribute but continues to hold the property upon which the stock issue rests. Its undivided profits previously invested in the enterprise continue to be so invested. Instead of being a "dividend" in any proper sense, the effect of the action is that there shall be no dividends of the accumulations capitalized. The aggregate interests of the stockholders remain unchanged and their proportional interests remain unchanged.

Thus, a 'stock dividend', or increase of capital stock against surplus accumulations, accomplishes two things:

(1) The amount represented by the 'stock dividend' is permanently classified so that it cannot be paid out as dividends.

(2) The number of shares is increased without affecting the title of the corporation to any part of the corporate property and without adding to the ratable interests of the stockholders.

Upon a liquidation immediately before the 'stock dividend', the stockholder would have received precisely the same amount as he would have received upon a liquidation immediately after the 'stock dividend'. So far as the paper, or stock certificate, issue is concerned, it is an evidence of an interest already owned and permanently capitalized.

These plain incidents of the transaction have been repeatedly and authoritatively described.

"The corporate property remains the same after the stock is increased as before and the interest of each stockholder in the corporate property is also unchanged."

Kaufman v. Charlottesville Woolen Mills Co.,
93 Va. 673, 675.

"After a stock dividend a corporation has just as much property as it had before . . . after such a dividend the aggregate of the stockholders own no more interest in the corporation than before. The whole number of shares before the stock dividend represented the whole property of the corporation, and after the dividend they represent that and no more. A stock dividend does not distribute property, but simply dilutes the shares as they existed before."

Williams v. Western Union Telegraph Co.,
93 N. Y. 162, 189.

"There is a clear distinction between the ordinary cash dividend, no matter when earned, and a stock dividend declared as in the case at bar. The one is a disbursement to the stockholder of accumulated earnings, and the corporation at once parts irrevocably with all interest therein. The other involves no disbursement by the corporation. *It parts with nothing to the stockholder.* The latter represents not an actual dividend, but certificates of stock which evidence in a new proportion his interest

in the entire capital, including such as by investment of accumulated profits has been added to the original capital."

DeKoven v. Alsop, 205 Ill. 309.

"It is the characteristic feature of a stock dividend that the property of the corporation itself remains unchanged, but that each one of the shares of the increased stock represents a smaller fractional interest than before in the total amount of the corporate property. On the other hand, it is the characteristic feature of a dividend declared and paid wholly from the net profits or undivided earnings that it does diminish the property of the corporation by exactly the amount of the dividend so paid out, while it leaves the fractional interest represented by each share of the capital stock exactly where it was before. *Gibbons v. Mahon*, 136 U. S. 549, 559, 560."

Gray v. Hemenway, 212 Mass. 239.

See also

Bouch v. Sproule, 12 App. Cas. 385.

Jones v. Evans (1913) 1 Ch. 23.

In re Carson, Irish Reports (1915) Vol. 1, p. 321.

Guinness, Trustee, v. Guinness, Cases Ct. of Session, 5th Series, Vol. 6, p. 104.

Minot v. Paine, 99 Mass. 101.

Davis v. Jackson, 152 Mass. 58.

D'Ooge v. Leeds, 176 Mass. 558.

Hyde v. Holmes, 198 Mass. 287.

Brown v. Larned, 14 R. I. 371, 373.

Billings v. Warren, 216 Ill. 281.

Lancaster v. Mason, 152 No. Car. 660.

Great Western Mining & Mfg. Co. v. Harris,
128 Fed. 321, 326.

In Connecticut, under whose laws The Yale & Towne Manufacturing Company was formed and the 'stock dividend' in question was issued, similar views have frequently been set forth in the decisions of the Supreme Court.

"The word 'dividends' if unqualified, signifies dividends payable in money. The word 'income' has a broader meaning, but hardly broad enough to include things not separated in some way from the principal. It is not synonymous with 'increases'. The value of stock may be increased by good management, prospects of business, and the like. But such increase is not income. It may also be increased by the accumulation of surplus; but so long as that surplus is retained by the corporation *either as surplus or as increased stock*, it can in no proper sense be called income."

Spooner v. Phillips, 62 Conn. 62, 68

"It is also one of the incidents of a stock dividend that the shareholder who receives his *pro rata* proportion of the new issue, while he

acquires the ownership of more shares, adds nothing to his proportionate ownership of the assets of the corporation. His holding, after the new issue, bears precisely the same ratio to the total of the outstanding shares as did his previous holding to the previous total (*Terry v. The Eagle Lock Co.*, 47 Conn. 141, 165). The underlying idea of a cash dividend, on the other hand, is the distribution to shareholders as the rewards of the corporate enterprise of a portion of the profits or surplus assets of the corporation. . . . Whatever form the distribution takes, the result always is the reduction of both the corporate assets and surplus by just the amount of the distribution. Something is taken from the corporation and given to the stockholders. All which is distributed becomes released from all corporate control and goes under the dominion of the share owners."

Green v. Bissell, 79 Conn. 547, 551.

See also

Terry v. Eagle Lock Co., 47 Conn. 141.

Brinley v. Grou, 50 Conn. 66.

A genuine dividend constitutes a debt between the corporation and the shareholders;¹ once declared it may not be rescinded² and an action may be brought on the debt.¹

¹*King v. Paterson*, 29 N. J. L. 504; *Hunt v. O'Shea*, 69 N. H. 600; *Lockhart v. Van Alstyne*, 31 Mich. 76; *Stoddard v. The Shetucket Foundry Co.*, 34 Conn. 542.

²*Wheeler Beers & Others v. The Bridgeport Spring Co.*, 42 Conn. 17; *Staats v. Biograph Co.*, 236 Fed. 454.

It is otherwise with a stock issue made to shareholders (commonly called a 'stock dividend'), for, as the directors do not divide anything and in substance merely readjust the symbols by which the shareholders own the net assets, they may recall their own action and leave the shareholders without grievance.

In *Staats v. Biograph Co.*, 236 Fed. 454, the Circuit Court of Appeals for the Second Circuit, holding that the action of a board of directors in declaring a stock dividend might be rescinded, said (p. 457):

"In this case it does not escape observation that the plaintiff's right to a stock dividend, if he has such a right and can enforce it, would gain him nothing. We say it would gain him nothing, because while a stock dividend would increase the number of his shares, it proportionately diminishes the value of each of his shares, leaving the aggregate value as it was before. He acquires the ownership of more shares but he adds nothing to his proportionate ownership of the assets of the corporation."

The question of the nature of a 'stock dividend' was considered by this Court in the leading case of *Gibbons v. Mahon*, 136 U. S. 549, where it was decided that it is in its nature capital and not income.

That was a case of a will bequeathing stock in a corporation and government bonds in trust to pay "the dividends on said stock and the interest on said

bonds as they accrue" to a daughter of the testator, and directing that upon her death "the said stock, bonds and income shall revert to the estate of the trustee." The corporation accumulated earnings from time to time, before and after the death of the testator, which were invested in its permanent works and plant. It declared a 'stock dividend' representing these accumulated earnings and the question was whether this 'stock dividend' was income. It was held to be capital and that it should go to the remainderman, only the dividends which might be received on such stock being payable to the tenant for life.

After reviewing the authorities of other jurisdictions, Mr. Justice Gray discussed the nature of a 'stock dividend';

"Money earned by a corporation remains the property of the corporation, and does not become the property of the stockholder, unless and until it is distributed among them by the corporation. The corporation may treat it and deal with it either as profits of its business, or as an addition to its capital. Acting in good faith and for the best interests of all concerned, the corporation may distribute its earnings at once to the stockholders as income; or it may reserve part of the earnings of a prosperous year to make up for a possible lack of profits in future years; or it may retain portions of its earnings and allow them to accumulate, and then invest

them in its own works and plant, so as to secure and increase the permanent value of its property" (p. 558).

"When a distribution of earnings is made by a corporation among its stockholders, the question whether such distribution is an apportionment of additional stock representing capital, or a division of profits and income, depends upon the substance and intent of the action of the corporation, as manifested by its vote or resolution; and ordinarily a dividend declared in stock is to be deemed capital, and a dividend in money is to be deemed income, of each share."

"A stock dividend really takes nothing from the property of the corporation, and adds nothing to the interests of the shareholders. Its property is not diminished, and their interests are not increased. After such a dividend, as before, the corporation has the title in all the corporate property; the aggregate interests therein, of all the shareholders are represented by the whole number of shares; and the proportional interest of each shareholder remains the same. The only change is in the evidence which represents that interest, the new shares and the original shares together representing the same proportional interest that the original shares represented before the issue of new ones" (pp. 559-60).

"The resolution is clearly an apportionment of the new shares as representing capital, and not a distribution or division of income. As well observed by Mr. Justice James, delivering

the opinion of the Court below: 'Certificates of stock are simply the representative of the interest which the stockholder has in the capital of the corporation. Before the issue of these two hundred and eighty new shares, this trustee held precisely the same interest in this increased plant in the capital of the corporation that she held afterwards. She merely had a new representative of an interest that she already owned, and which was not increased by the issue of the new shares. A dividend is something with which the corporation parts, but it parted with nothing in issuing this new stock. It simply gave a new evidence of ownership which already existed. They were not in any sense, therefore, dividends for which this trustee had to account to the *cestui que trust*. She stood after the issue of the new shares just as she had stood before; and the trustee was obliged to treat them just as she did, namely, as a part of the original, and to pay the dividends to the *cestui que trust*' " (p. 569).

Gibbons v. Mahon was long held under advisement by the Court, and it is apparent that it was decided after the most thorough consideration. We have quoted at length from the opinion, because the *ratio decidendi* renders unavailing the efforts which have been made to distinguish this case. Thus, it is said in the opinion of the District Judge that the stock dividend under consideration in the *Gibbons* case was "prin-

cipally based upon a surplus earned prior to the creation of the trust which received it" (fol. 36). Not only is this suggestion inapposite here, but, as was pointed out by this Court in the Gibbons case, a large part of the surplus—by no means negligible—was there accumulated *after* the trust was created (*id.*, pp. 550, 569). Again, it has been argued that the case arose under a will, and in the District of Columbia. But the Court was not dealing with a question of local law; it dealt with a general principle. The Court explicitly rests its decision upon *the essential nature of the transaction*,—that is, upon a consideration of the essential quality of a 'stock dividend' based there, as here, on accumulated surplus invested in plant and property and by appropriate resolution permanently classified as capital. The opinion makes it clear that it was not a rule particularly applicable to wills, or trusts, but the nature and effect of the corporate action which determined the conclusion of the Court. If the 'stock dividend' was not receivable as income, when if income the claimant would have been entitled to receive it, it could hardly be said that it should be taxed as income. Had it been income, the *cestui que trust* would have succeeded, but because the Court considered it *not* to be income she lost her suit. If the 'stock dividend' was not income for the purpose of distribution to the beneficiary of the income, we cannot conceive that it could have been regarded, had an income tax law

been in operation, as income for the purpose of taxing it.

Gibbons v. Mahon was an exposition by which the final authority defined to this extent, by exclusion, the meaning of "income". The usual rule is that when a word which has received judicial construction is subsequently used in Federal legislation it should be presumed to have been used in the sense determined by the Court (*Kepner v. United States*, 195 U. S. 100, 124; *Latimer v. United States*, 223 U. S. 501, 504). And this principle, it is submitted, should be applied in the construction of both Amendment and statute. Authoritative judicial decision is our glossary of terms used in statutes and constitutions.

It is evident that this Court in its exhaustive examination of the subject in the *Gibbons* case fully considered the provisions of the Income Tax Acts of 1862 and 1864, and in particular the statements of Mr. Justice Clifford in *Bailey v. N. Y. C. & H. R. R. Co.*, 22 Wall, 604. The Court recognized that the opinion delivered by Mr. Justice Clifford in the case cited, contained "some general expressions which taken by themselves might seem to ignore the settled distinction (affirmed by this Court in earlier and later cases above cited) between the property of the corporation and the interests of the shareholders". But it was pointed out that in the *Bailey* case the question arose "*between the corporation and the government*", and that the decision

depended "upon the terms of a statute carefully framed to prevent corporations from evading payment of the tax upon their earnings".¹

The provision of Section 122 of the Act of June 30, 1864, c. 173, 13 Stat. 223, 284 (see also Act of July 13,

¹The full text of the reference in *Gibbons v. Mahon*, *supra*, to the case of *Bailey v. Railroad Co.*, *supra*, is as follows: "In *Bailey v. Railroad Co.*, 22 Wall. 604, cited for the plaintiff, the point decided was that certificates, issued by a railroad corporation to its stockholders as representing earnings which had been used in the construction and equipment of its road, and payable, at the option of the company, with dividends like those paid on the stock, were within that provision of the internal revenue laws, which enacted that any railroad company 'that may have declared any dividend in scrip or money due or payable to its stockholders', 'as part of the earnings, profits, income or gains of such company, and all profits of such company carried to the account of any fund, or used for construction, which shall be subject to and pay a tax of five per centum on the amount of all such' 'dividends or profits, whenever and wherever the same shall be payable, and to whatsoever party or person the same may be payable'. Acts of June 30, 1864, c. 173, sec. 122, 13 Stat. 284; July 13, 1866, c. 184, sec. 9, 14 Stat. 138, 139. The question at issue was not between the owners of successive interests in particular shares but between the corporation and the government, and depended upon the terms of a statute carefully framed to prevent corporations from evading payment of the tax upon their earnings. The opinion delivered by Mr. Justice Clifford, though containing some general expressions which, taken by themselves, might seem to ignore the settled distinction (affirmed by this court in earlier and later cases above cited), between the property of the corporation and the interests of the shareholders, yet explicitly recognized that 'net earnings of such a company may be expended in constructing or equipping the railroad, or in the purchase of real estate or other properties', and 'may be distributed in dividends of stock or of scrip or of money'; that 'purchasers of stock have a right to claim and receive all dividends subsequently declared, no matter when the fund appropriated for the purpose was earned'; that, 'as a general rule, stock dividends, even when they represent net earnings, become at once a part of the capital of the company', and that 'such a dividend, if earned and declared, necessarily increases the value of the old stock, if new stock is not issued, and in that mode reaches substantially the same result'. 22 Wall. 635-637" (pp. 560-561).

1866, c. 184, 14 Stat. 98, 138), which was involved in the *Bailey* case, was as follows:

"That any railroad, canal, . . . company indebted for any money for which bonds or other evidence of indebtedness have been issued, payable in one or more years after date, upon which interest is stipulated to be paid, or coupons representing the interest, or any such company that may have declared any dividend in scrip, or money due or payable to its stockholders, as part of the earnings, profits, income, or gains of such company, and all profits of such company carried to the account of any fund, or used for construction, shall be subject to and pay a duty of five percentum on the amount of all such interest, or coupons, dividends, or profits, whenever the same shall be payable; . . .".

There was a long standing difference of opinion in this Court upon the question whether this tax under the Act of 1864 was upon the corporation with respect to its earnings, or upon the income of the stockholder or bondholder, as such.¹

The final result was stated in *Railroad Company v.*

¹*Barnes v. The Railroads*, 17 Wall. 294, 309, 319; *United States v. B. & O. R. R. Co.*, 17 Wall. 322; *Stockdale v. Atlantic Insurance Co.*, 20 Wall. 329, 337; *Bailey v. N. Y. C. & H. R. R. Co.*, 22 Wall. 604; *Railroad Company v. Collector*, 100 U. S. 595; *Bailey v. N. Y. C. & H. R. R. Co.*, 106 U. S. 109; *United States v. Erie Railway Co.*, 106 U. S. 327, 329, 330, 331; *Memphis & Charleston R. R. Co. v. United States*, 108 U. S. 228, 234. See *United States v. L. & N. R. R. Co.*, 33 Fed. pp. 831, 832; *Pollock v. Farmers Loan & Trust Company*, 157 U. S. p. 578.

Collector, 100 U. S. 595, 598, where it is said, referring to the provision of the Act of 1864 above quoted:

"The tax, in our opinion, is essentially an excise on the business of the class of corporations mentioned in the statute. . . . The corporations mentioned in this section are those engaged in furnishing road-ways and water-ways for the transportation of persons and property, and the manifest purpose of the law was to levy the tax on the net earnings of such companies. How were these 'earnings, profits, incomes, or gains' to be most certainly ascertained? In every well-conducted corporation of this character these profits were disposed of in one of four methods; namely, distributed to its stockholders as dividends, used in construction of its roads or canals, paid out for interest on its funded debts, or carried to a reserve or other fund remaining in its hands. Looking to these modes of distribution as the surest evidence of the earnings which Congress intended to tax, and as less liable to evasion than any other, the tax is imposed upon all of them. The books and records of the company are thus made evidence of the profits they have made, and the corporation itself is made responsible for the payment of the tax."

This determination was expressly followed in *United States v. Erie Railway Co.*, 106 U. S. 327, 330—where bonds were involved—and it was distinctly

recognized in that case (in the last expression of dissent) that the court had held the tax to be "an excise on the business of the class of corporations mentioned", and hence as levied "not on the bondholder who receives the interest but upon the earnings of the corporations which pay it" (*id.*, p. 337). Mr. Justice Clifford was one of the majority whose views as to the nature of the tax ultimately prevailed and his expressions in the first *Bailey* case should be taken accordingly".¹

In the present case the nature of the tax is indisputable. The Yale & Towne Manufacturing Company had paid its excise tax, and there was no attempt to reassess it with respect to any of its earnings. The tax in question was levied under the provisions of the Income Tax Act of 1913 relating to the individual stockholder and was levied in this case upon his property as such.

¹The Act of July 1, 1862, c. 119, sec. 81, 12 Stat. 432, 469, had a similar tax of 3%. See *Chicago, Burlington & Quincy R. R. Co. v. Page*, 1 Biss. 461.

2. The stock in question was based on earnings which had been accumulated by the corporation prior to January 1, 1913, that is, prior to the adoption of the Sixteenth Amendment, and neither this stock nor the accumulated surplus which it represented was subject to taxation without apportionment as being income within the meaning of that Amendment.

The decisions cited by the District Judge, with respect to apportionment between tenant for life and remainderman, in cases of 'stock dividends' (*Matter of Osborne*, 209 N. Y. 450; *Lozery v. Farmers' Loan & Trust Co.*, 172 N. Y. 137; *Will of Pabst*, 146 Wisc. 330) and similar decisions rest upon the supposed intention of the testator. In other words, where a 'stock dividend' in whole or in part is based upon earnings accumulated after the creation of the trust and during the period of the interest of the life beneficiary, the apportionment is made by these decisions in order to secure to the life beneficiary that which it is considered the testator intended he should have. These cases rest not upon a consideration of the stock interest, in itself, as apart from the nature of the accumulated surplus upon which it is based, but rather upon an appreciation of a supposed equity growing out of the relation of the 'stock dividend' to earnings accumulated during the period of the trust for the benefit of the claimant. The courts which have rendered these decisions look through the 'stock dividend' to the nature of the surplus and base their decisions accordingly.

In the present case, however, this method of approach cannot aid the Government. Whether we con-

sider the 'stock dividend', according to its essential nature as a mere readjustment of the evidence of the interest, or look through it to the accumulated surplus upon which it rests, the result must be the same.

It is the decided weight of authority even in those jurisdictions which have established a doctrine of apportionment between the tenant for life and remaindermen, that a 'stock dividend' does not go to the life beneficiary of the income, in case the stock, where it is issued *after* the creation of the life tenancy, is based on surplus accumulated *before* the life tenancy began.¹ Almost all the Courts which adopt an "apportionment" theory agree that, in the absence of special provisions to the contrary in a will or deed of trust, 'stock dividends' capitalizing earnings which were accumulated before the trust was created are to be treated as principal or capital to be held for the remainderman, and are not income for the life beneficiary. As Mr. Thompson says, "if they are found to represent earnings that accrued prior to the creation of the trust, they belong to the *corpus* of the trust" (Thompson on Corporations, sec. 5414).² If, under

¹There are decisions in Kentucky holding that stock based on earnings, though accumulated before the creation of the trust or life estate, go to the tenant for life. (*Hite v. Hite*, 93 Ky. 257; *Cox v. Gaulbert's Trustee*, 148 Ky. 407.) These decisions are not only flatly opposed to *Gibbons v. Mahon*, *supra*, but to the overwhelming weight of both American and English authority. It is also apparent that Kentucky has misunderstood the New York rule. See *Cox v. Gaulbert's Trustee*, *supra*; *Matter of Osborne*, 209 N. Y. 450.

²*Earp's Appeal*, 28 Pa. State, 368; *Holbrook v. Holbrook*, 74 N. H. 201; *Thomas v. Gregg*, 78 Md. 560; *Prichard v. Nashville Trust Co.*, 96 Tenn. 472. For other citations on the question of apportionment see Cook on Corp., 7th Ed., Sec. 554 *et seq.*

the New York rule, the case of *Lowry vs. Farmers' Loan & Trust Company* (172 N. Y. 137) can be said to have generated any doubt of this proposition, it was dispelled by *Matter of Osborne* (209 N. Y. 450). There, the court, while giving to the life beneficiary a part of the 'stock dividend' which was earned after the creation of the testator's trust, distinctly ruled that the part earned previously should "be retained by the executor as part of the capital of the trust fund". It was deemed that to give that portion of the 'stock dividend' as income to the life beneficiary would "shock the sense of justice" (*id.*, p. 477). So in New Jersey, the right of the tenant for life to 'stock dividends' is limited to those based on earnings after the creation of the estate. (*Lang v. Lang's Executor*, 57 N. J. Eq. 325; *Day v. Faulks*, 79 N. J. Eq. 66; 81 *id.* 173.) And in *Will of Pabst* (146 Wis. 330), while the court showed decided hostility to the rule established by this Court, nevertheless approval was expressed of the doctrine that inquiry should be made "as to the *time* when the fund out of which the extraordinary dividend is to be paid was earned or accumulated, and also to the method of accumulation", and that "if it is found to have accrued or been earned *before* the life estate arose, it may be held to be principal; and without reference to the time when it is declared or made payable, to belong to the *corpus* of the estate and *not* to go to the life tenant" (*id.*, p. 340).

It is apparent that if a 'stock dividend', based on accumulated earnings which are capitalized by proper

corporate action during a life tenancy, constitutes *income per se*, it would not be of consequence to inquire when and how the fund had been accumulated; it would go as a matter of course to the tenant for life or beneficiary of the income. Being income, it would belong to the person to whom income was to be paid. But the authorities which have established rules recognizing the equities of the life beneficiary are almost unanimous in holding that there is no equity or right to have such a 'stock dividend' treated as income save to the extent that it is based upon earnings of the corporation arising after the creation of the trust, that is, accumulated during the life tenancy. To repeat, in search of the supposed equity, the courts upon whose decisions the Government has hitherto relied, look through the 'stock dividend' to the fund upon which it is based. The limitation, however, of the principle of these decisions, destroys the argument for the Government based upon them; it is a limitation inconsistent with the position that the 'stock dividend' should be regarded as income *per se*. And when, in this case, we look through the stock dividend to the fund upon which it rests, we find a surplus invested in plant and property, all of which had been accumulated prior to January 1, 1913.

The Sixteenth Amendment had no application to income or earnings accumulated prior to its adoption. It was not the purpose to endow the Congress with

power to reach, without apportionment, accumulations of property already effected.

In the *Brushaber* case, the Act of 1913 was assailed because of a "limited retro-activity" in making the law applicable to income from March 1, 1913. In answering this contention the Court pointed out (*id.*, p 20) that "the date of the retro-activity *did not extend beyond the time when the Amendment was operative*" and it was in this view that the Act was sustained.

"Constitutions as well as statutes are construed to operate prospectively only, unless, on the face of the instrument or enactment, the contrary intention is manifest beyond reasonable question."

Shreveport v. Cole, 129 U. S. 36, 43.

It would be difficult to conceive a case more clearly calling for the application of this principle than that of a constitutional amendment altering a rule as to taxability and drawn, as was said in the *Brushaber* case, "for the purpose of doing away *for the future* with the principle upon which the *Pollock* case was decided" while not "changing the existing interpretation except to the extent necessary to accomplish the result intended".

Gibbons v. Mahon being opposed, the Amendment being prospective, and the "apportionment" cases being unavailing (and in fundamental conception also opposed), nothing is left to support the decision below

but the contention that a 'stock dividend' is *per se* income regardless of the status of the accumulations upon which it rests. We conceive the arguments thus adduced to be wholly fallacious.

Thus it is stated by the District Judge (fol. 23) that "the whole matter" turns on the "new rights" which the stockholder gets through the "stock dividend". But what is the nature of these new rights? A "new right" is not necessarily income. By appropriate corporate action there may be a right created to subscribe for increased stock, or a right to convert stock into bonds, or *vice versa*, but no one would assert that such new rights constitute "income". A new number of shares is created, and there is a new number of votes corresponding. But these are not "income", and the stockholder's relative voting interest is precisely the same as before.

We are concerned here with the *property interest* represented by the stock in question upon which the plaintiff has been taxed. This stock represents (1) the right to have the corporate property managed according to the fundamental compact or contract of membership; (2) the right to receive dividends, when duly declared, that is, amounts separated from the corporate assets and vested in the stockholders individually; and, (3) the ratable interest in the aggregate of the corporate assets to which the stockholder would be entitled upon liquidation.

With respect to management, the stockholder's rights are unchanged save to the extent that the accu-

mulated surplus, which existed before January 1, 1913, and is represented by the new stock, is no longer subject to the discretion of the directors in distribution but is classified as capital and must be retained by the corporation as such.

With respect to dividends that may be declared upon this stock,—whenever any such dividend is declared and there is thus segregated from the corporate property an amount which the stockholder receives, he will be taxable accordingly.

There remains simply the stockholder's ratable interest in the aggregate corporate assets. This is precisely the same as it was before, and a liquidation before and after issue of the new stock would have given the plaintiff the same amount. For example, if a corporation on March 1, 1913, had capital stock of \$3,000,000 in par value and a surplus of \$3,000,000 and its aggregate shares were accordingly worth in the market \$6,000,000, neither its aggregate value nor the proportionate interest of each stockholder would be altered by a stock dividend, whether that stock dividend was of \$1,000,000, making the capital \$4,000,000 and the surplus \$2,000,000; or of \$2,000,000 making the capital \$5,000,000 and the surplus \$1,000,000; or of the entire surplus. In any case, upon liquidation, the stockholder would receive the same amount and the value of his interest, and the interest itself, in the aggregate corporate assets would be exactly the same. Yet under the decision below, although the entire \$6,000,000 of net assets existed on January 1, 1913, prior to the adoption

of the Amendment, if a 'stock dividend' were issued of \$3,000,000, the stockholders would pay an income tax for the year 1913 on \$3,000,000 on the theory that they had received this amount in "income".

It is no answer to say that if they had received dividends in cash of \$3,000,000 they would have been taxable upon this amount. We are not concerned with the question whether such "extraordinary dividends" payable out of previous accumulations could be considered income, for it is apparent that if they could possibly be so considered, it would be solely because the moneys had come into the separate ownership of the stockholder and thus segregated from the corporate assets. Here the stockholder has received nothing but evidence of an interest already owned in corporate assets permanently retained by the corporation and not distributed.

What then is the "new right" of the stockholder? It is nothing more than the right to have dividends *on* the new stock when duly declared and the right to have the amount represented by the new stock treated as capital and not distributed. How can this be taxable income?

What has been said is also an answer to the argument below, that the stockholder has something "different",—for this "difference" and the "new right" referred to in the opinion below, are manifestly the same thing.

Further, it is argued that the effect is the same as though a cash dividend had been declared, and its

amount received by the plaintiff, and he had then invested this amount in the new stock. But, putting aside any question as to the status of such "extraordinary dividends" in cash based on accumulations prior to January 1, 1913, it is manifest that the two things mentioned, instead of being the same, are different, both legally and practically. When the cash dividend is declared and the amount is received, the stockholder obtains something which he owns and which he may reinvest or not as he pleases. He receives property in his exclusive ownership, and he exercises the freedom of choice. In the case of a 'stock dividend', he obtains nothing but an evidence of what he already owns; he has no freedom to invest or not invest; and the investment is permanently capitalized. This distinction was pointed out in *Davis v. Jackson*, 152 Mass. 58.

The point of the remark of Lord Eldon in *Paris v. Paris*, 10 Vesey, Jr. page 189, quoted by the District Judge (fol. 22), is not that a 'stock dividend' is income, but quite the reverse. It was the settled law in England that such a 'stock dividend' was not income and the question was whether "extraordinary" money dividends should be placed in a different category. Whatever may be thought with respect to this, the nature of a 'stock dividend' based on a capitalization of surplus, as clearly defined by this Court in the *Gibbons* case, cannot be obscured by any question as to the status of moneys taken out of the corporate assets and actually paid to the stockholders as their separate property.

The District Judge also argues that the certainty

that these prior earnings of the corporation could thenceforth never be distributed as dividends, was a valuable assurance of the continued solvency of the company to the stockholder, and that this assurance was subject to a tax as income of the individual stockholder.

“He has lost the chance of cash dividends and gained an interest in the corporate enterprise that cannot be taken away” (fol. 39).

But before the ‘stock dividend’, the stockholder’s interest in the corporate assets could not be taken away, except through mismanagement or losses, and his interest continues to be subject to these contingencies as before. Previously, if there were distribution in cash, he would receive his dividend and own the amount. The proposition that the certainty that a man will never receive a given fund is equivalent to his actual receipt of that fund will appeal less to the shareholder’s sense of logic than to his sense of humor.

The argument that a ‘stock dividend’ is income fails to distinguish between the effect of the dollar sign printed on the certificates of stock as indicating the amount contributed to “capital”, and the interest of the stockholder in the aggregate corporate assets, with which this dollar sign, or the par value of his shares, has nothing to do. As to the corporation, its net assets are divided into two groups, “capital” and “surplus”, with different legal attributes, and the dividing line between the two groups is shown by the nominal or

par value of the company's stock, or the amount of the contributed "capital".

In the case at bar, for example, The Yale & Towne Manufacturing Company had \$3,000,000. of capital stock, and approximately \$5,000,000. of assets. The \$3,000,000. of capital was divided into 30,000 shares of the par value of \$100. each. These \$3,000,000. represented, in a general sense, a trust fund to be used by the corporation in the conduct of its business and for the payment of its debts; none of it could lawfully be separated from the company and paid to its stockholders. The other \$2,000,000., approximately, of its assets represented surplus which the company was free to dispose of in any manner that it saw fit. There were 30,000 shares of stock outstanding; the dollar mark on each certificate, indicating the par value of each share, was of importance in indicating the amount of the contributed capital stock, and therefore the dividing line between these two groups of its net assets.

But there was no such distinction with regard to the stockholder's interest in the aggregate corporate assets. As to this the dollar mark on his certificate was immaterial. Each share of stock represented $1/30,000$ part of the net assets of the corporation, and those assets might amount to \$1,000,000. or \$50,000,000., and this was true whether his stock had a nominal par value or whether, as is permitted in various States, it was "no par value" stock.

When it is argued that in receiving a 'stock dividend', a stockholder receives from the corporation

something of value which must therefore be income, there is an inaccuracy in terms. If I exchange a two-dollar bill with the money changer for two one-dollar bills, I have, it is true, received from him something of value, but my property interest remains entirely unchanged, and I have surely not received any "income".

If The Yale & Towne Manufacturing Company had outstanding 30,000 shares of capital stock of the nominal or par value of \$100. each, and had issued in exchange therefor 60,000 shares of the nominal or par value of \$50. each, each stockholder would have received an increased number of tangible evidences of his ownership in the assets of the corporation. He would have no greater interest in the assets of the corporation than he had before, and the dividends he might thereafter receive on his holdings of \$50. shares would be just as large as if he received dividends on his original \$100. holdings. But the Government would not contend that such an alteration of the stockholder's certificates constituted income.

In this same line the Government conceded below and must concede here that if a corporation having a million dollars of capital and with no surplus, waters its stock and issues a 50 per cent. 'stock dividend' to its stockholders, the new stock, not representing an increase of assets, would not constitute taxable income in the hands of the shareholder; the receipt by the stockholder of certificates of stock having an increased nominal or par value does not increase the stockholder's

real interest in the corporation, and therefore the change does not constitute income.

The effect of this concession cannot be overcome. It is conceded that the increase of the number of shares into which the assets of the corporation are divided, or the issue of a new series of fractional certificates, does not constitute income to the stockholder if the corporation has no accumulated surplus, even though the nominal or par value of the shares of stock owned by each stockholder is thereby increased. It is conceded that mere increase in the number of shares into which the capital of a corporation is divided does not constitute income, and this regardless of the question whether the corporation has available accumulated surplus or not. And it is just as true that the stockholder's interest in the aggregate corporate assets remains unchanged when there is an increase of stock based on accumulated surplus. The change is simply that the amount is permanently capitalized so that it cannot be distributed without liquidation and on liquidation the stockholder would receive no more than before.

Of course the salability of the new shares presents no more argument for the existence of "income" than does the salability of the old shares at an increased price because of the accumulated earnings back of them. A sale in either case would have the same effect.

If one had 9,000 shares previously, and received 4,500 additional shares through a stock dividend based

on surplus accumulations, he of course could sell any portion of the total 13,500 shares. And if he sold 4,500 of the 13,500 shares he would receive the equivalent in cash. But he could have realized the same amount prior to the stock dividend by selling 3,000 shares of his original 9,000 shares. His intrinsic interest is the same, and the transaction has not affected its value.

III.

IT WAS NOT THE INTENTION OF CONGRESS IN THE ACT OF OCTOBER 3, 1913, TO TAX 'STOCK DIVIDENDS' AND CERTAINLY NOT TO TAX STOCK DIVIDENDS BASED ON SURPLUS ACCUMULATIONS EXISTING PRIOR TO JANUARY 1, 1913. UNDER A PROPER CONSTRUCTION OF THE STATUTE THE TAX ON THE STOCK IN QUESTION WAS NOT JUSTIFIED.

1. 'Income' in an income tax law, unless it is otherwise specified, means cash or its equivalent. It does not mean choses in action or unrealized increments in the value of property.

"In the absence of any special provision of law to the contrary, income must be taken to mean money and not the expectation of receiving it, or the right to receive it, at a future time."

United States v. Schillinger, 14 Blatch. 71.

"The mere fact that property has advanced in value between the date of its acquisition and sale does not authorize the imposition of the tax on the amount of the advance. Mere advance in value in no sense constitutes the gains, profits, or income specified by the statute. It constituted and can be treated merely as increase of capital."¹

Gray v. Darlington, 15 Wall. 63, 66.

¹Under the British Income Tax Act (16 & 17 Vict. c. 34) it is established that appreciations in value of capital assets, even after the realization of profits by sale, do not constitute taxable income except in cases of transactions by dealers or other persons who buy and sell for purposes of profits. *Tebrau (Johore) Rubber Syndicate, Limited, v. Farmer, S. T.*, 5 Income Tax Cases, 658; *Stevens v. The Hudson's Bay Company*, 5 Income Tax Cases, 424; *The Assets Company, Ltd. v. The Inland Revenue*, Cases in the Court of Session, 4th Series, Vol. 24, p. 578.

Thus, under the Corporation Tax Act of 1909, it has been held that a corporation was not taxable on the increased value of its assets, as shown upon its books as the result of a reappraisal, where there had been no actual sale.

Baldwin Locomotive Works v. McCoach
(C. C. A. Third Circuit), 221 Fed. 59;
Industrial Trust Co. v. Walsh (D. C. Conn.),
222 Fed. 437.

As was said in *Baldwin Locomotive Works v. McCoach*, *supra*:

"We agree with the District Court that this increase of valuation was not income within the meaning of the statute. Nothing whatever was added to the corporate property, which remained exactly the same after the appraisement as before. The only thing done was to put upon the company's books an expression of expert opinion that certain property was worth a certain sum, and this can hardly be said to be income, or even gain, in any proper sense. The company would not become either richer or poorer by making a few book entries that merely recorded a new estimate of how much it was worth" (p. 60).

The case of *Edwards v. Keith* (C. C. A. Second Circuit), 231 Fed. 110, upon which the District Judge largely relies in the case at bar, presents—as we view it—no analogy whatever to the present case. There the plaintiff was a life insurance agent who received certain commissions in the year 1913, upon policies

which had been written prior to March first of that year. He was merely taxed with respect to what he had actually received in cash as income during the tax year. As the Court said: "But no instructions of the Treasury Department can enlarge the scope of this statute so as to impose the income tax upon unpaid charges for services rendered and which, for aught any one can tell, may never be paid" (p. 113). Plaintiff was not taxed upon expectations, or *choses in action*, or unrealized benefits, but simply upon his cash income.

"The word 'income' as used in revenue legislation has a settled legal meaning. The courts have uniformly construed it to include only the receipt of actual cash as opposed to contemplated revenue due but unpaid unless a contrary purpose is manifest from the language of the statute."¹

Maryland Casualty Co. v. U. S., Court of Claims Decision, No. 33,191, Feb. 12, 1917.

¹See also, *Conn. Mutual Life Ins. Co. v. Eaton*, 218 Fed. Rep. 206; and *Herold v. Mutual Benefit Life Ins. Co.*, 198 Fed. Rep. 199; affirmed in 201 Fed. Rep. 918; and *Conn. Genl. Life Ins. Co. v. Eaton*, 218 Fed. Rep. 188.

2. The stock in question was not a "dividend" within the meaning of the word "dividends" as used in the Act of 1913. If Congress had intended to embrace 'stock dividends' based on surplus accumulations capitalized, Congress would have said so.

The word "dividends" was used in its natural sense as referring to moneys or property separated from the corporate assets and vested in the separate ownership of the stockholders.¹

"This word ('dividends'), when used in reference to corporate stocks, has a technical but well understood meaning, and indicates corporate funds derived from the business and earnings of the corporation, appropriated by a corporate act to the use of and to be divided among the stockholders."

Hyatt v. Allen, 56 N. Y. 553, 556.

"A dividend is something with which the corporation parts, but it parted with nothing in issuing this new stock. It simply gave a new evidence of ownership which already existed".

Gibbons v. Mahon, 136 U. S. 549, 569.

It is to be presumed that Congress used the words "dividends" and "income" in the Act of 1913 with reference to the sense in which they had been judicially defined by this court (*Kepner v. United States*, 195

¹See *De Koven v. Alsop*, 205 Ill. 309, 313; *City of Allegheny v. Pittsburgh A. & M. P. Rwy. Co.*, 179 Pa. 414; *State v. Comptroller*, 54 N. J. Law, 135; *Williston v. Michigan Co.*, 95 Mass. 400, 404.

U. S. 100, 124; *Latimer v. United States*, 223 U. S. 501, 504; *Logan v. United States*, 144 U. S. 263, 301).

It is not to be supposed that Congress in its use of these words without further specification intended to embrace 'stock dividends' like the one in question which had previously been held not to be "dividends" or "income" in *Gibbons v. Mahon* (*supra*). Had there been such intention it would have been disclosed in appropriate terms.

Paragraph B of the Income Tax Section of the Act of 1913 (38 Stat., p. 167; see Appendix) provides that in computing the individual's net income "for the purpose of the normal tax" there shall be allowed as one of the deductions:

"seventh, the amount received as dividends upon the stock or from the net earnings of any corporation, joint stock company, association, or insurance company which is taxable upon its net income, as hereinafter provided."

That is, it was not intended that the individual stockholder should pay any tax, so far as the normal tax is concerned, upon "dividends". And what he is entitled to deduct is "the amount received" as dividends. Where the corporation has paid upon its net earnings, the stockholder, with respect to the normal tax, is not to pay upon the amounts segregated from these earnings and paid over to him to be held as his separate property.

With respect to the super-tax or "additional tax", there is explicit provision in Paragraph A for including in the "taxable income" of the stockholder, in a certain contingency, his share of the undivided profits of the corporation, but he is to be taxed with respect to this share only in case they are fraudulently withheld from distribution and in the particular circumstances defined by the paragraph, viz. (see Appendix):

"For the purpose of this additional tax the taxable income of any individual shall embrace the share to which he would be entitled of the gains and profits, if divided or distributed, whether divided or distributed or not, of all corporations, joint-stock companies, or associations *however created or organized, formed or fraudulently availed of* for the purpose of preventing the imposition of such tax through the medium of permitting such gains and profits to accumulate instead of being divided or distributed; and the fact that any such corporation, joint-stock company, or association, is a mere holding company, or that the gains and profits are permitted to accumulate beyond the reasonable needs of the business shall be *prima facie* evidence of a fraudulent purpose to escape such tax; but the fact that the gains and profits are in any case permitted to accumulate and become surplus shall not be construed as evidence of a purpose to escape the said tax in such case *unless the Secretary of the Treasury shall certify that in his opinion such accumulation is unreasonable for the purposes of the business.* When

requested by the Commissioner of Internal Revenue, or any district collector of internal revenue, such corporation, joint-stock company, or association shall forward to him a correct statement of such profits and the names of the individuals who would be entitled to the same if distributed."

This is a very clear indication of the intent of Congress that the stockholder was not to be taxed at all with respect to the normal tax, so far as undivided profits of the corporation were concerned; and that he was not to be taxed through the super-tax or additional tax, with respect to any interest in undivided profits of the corporation save in the case particularly specified of a fraudulent withholding and where the Secretary of the Treasury had certified that the accumulation was not a reasonable one for the purposes of the business.

The Act of 1913 is thus significant in what it contains and in what it does *not* contain. It makes special provision for taxing the stockholder with respect to his interest in the undivided profits of the corporation, a provision which is to be applicable only in the stated contingency, while at the same time it contains no mention whatever of 'stock dividends'. When we consider the nature and effect of stock issues based on surplus, the fact that the property of the corporation remains the same, that the stockholder's interest is not increased, and that he has received through the stock issue no part of the corporate assets, the significance of this express

provision of the Act, taken in connection with the omission of all reference to 'stock dividends', seems to us very plain. There is certainly no controlling reason why in the absence of any special provision to that effect the stockholder should be taxed with respect to undivided profits which have been capitalized for the just needs of the corporate enterprise, and not taxed with respect to undivided profits which have not been capitalized. And the fact that Congress has made a careful and limiting provision which excludes the stockholder's interest in undivided profits, where these are honestly withheld from distribution for the purposes of investment in plant and property, is sufficient to show that it was not intended under the word "dividends" or "income" without further specification to include stock issues which merely capitalized surplus accumulations thus invested.

What has been said is also sufficient to meet any suggestion based on the general words of Paragraph B that net income shall include "gains or profits and income derived from any source". These words have their appropriate reference to what is embraced in "income" and not to that which is not normally income, certainly not to that which this court had held *not* to be "income". Congress by this clause manifestly did not intend to put in the category of 'dividends' what did not appropriately belong in that category; and with respect to interests in undivided corporate gains, the clause in Paragraph A to which we have referred shows that there was no intention either under the

word 'dividends' or under the general words "gains or profits and income" to reach a stockholder's share in undivided profits which had been held without fraud for the proper benefit of the corporate enterprise, and upon which, so far as the accumulation consisted of earnings, the corporation itself would be taxable. Whether these were capitalized or not did not affect the stockholder's "gains or profits and income". Under the Act of 1913 the stockholder was to pay only on the 'dividends' which he received, that is, on the amounts separated from the corporate assets and paid to him as his separate property.

If Congress had intended anything more its intention would have been expressed.

3. The tax for which the Act of 1913 provides is an annual tax upon the entire net income arising or accruing in the preceding calendar year. For the year 1913 the tax was to be computed on the net income accruing after March first.

The Act provides (38 Stat. 166):

"A. Subdivision 1. That there shall be levied, assessed, collected and paid *annually* upon the entire net income *arising or accruing* from all sources *in the preceding calendar year*. . . .

"D. The said tax shall be computed upon the remainder of said net income of each person subject thereto, accruing during each preceding

calendar year ending December thirty-first: *Provided*, however, that for the year ending December thirty-first, nineteen hundred and thirteen said tax shall be computed on the net income *accruing from March first to December thirty-first*, nineteen hundred and thirteen, both dates inclusive, after deducting five-sixths only of the special exemptions and deductions herein provided for."

This explicit language puts it beyond question that Congress did not intend to tax surplus accumulations, or interests therein, which had accrued prior to March 1, 1913.

The question is not like that which arose in *Stockdale v. Insurance Companies*, 20 Wall. 323, where Congress, having full power in the premises, had provided in the Act there under consideration (July 14, 1870, 16 Stat. 261) that the tax should relate to the earnings of the year there in question; and, as the Court said, the question would never have arisen except for the use of the expression that the sections should be "construed" to impose the taxes for the given period. The Court held that in the use of the word "construed" Congress plainly meant that the taxes were to be continued in full force (*id.*, p. 331).

The rule of *Gray v. Darlington*, 15 Wall. 63, with respect to the meaning of "annual" gains is pertinent here,—especially as the Act of 1913 limited the tax to income "arising or accruing" in the prescribed period.

That case arose under the Act of March 2, 1867 (14 Stat. 477, 478) in which it was provided:

"There shall be levied, collected and paid *annually* upon the gains, profits and income of every person . . . whether derived from any kind of property, rents, interest, dividends, or salaries, or from any profession, trade, employment, or vocation, . . . or from any other source whatever . . . a tax of five per centum on the amount so derived over one thousand dollars,"

The plaintiff, in 1865, exchanged certain United States Treasury notes for United States five-twenty bonds and in 1869 sold the bonds at an advance of \$20,000 over the cost of the Treasury notes. The Collector assessed a tax upon this amount as "income" for the year 1869. This Court held that the tax was unauthorized. The Court said:

"The advance in value of property during a series of years can, in no just sense, be considered the gains, profits, or income of any one particular year of the series, although the entire amount of the advance be at one time turned into money by a sale of the property. . . .

"The rule adopted by the officers of the revenue in the present case would justify them in treating as gains of one year the increase in the value of property extending through any number of years, through even the entire century. The actual advance in value of property over its cost, may in fact reach its height years

before its sale; the value of the property may, in truth, be less at the time of the sale than at any previous period in ten years, yet, if the amount received exceed the actual cost of the property, the excess is to be treated, according to their views, as gains of the owner for the year in which the sale takes place" (pp. 65-67).

In *Merchants' Insurance Company v. McCartney*, 1 Lowell, 447, the question arose under provisions of the Income Tax Act of June 30, 1864, c. 173 (13 Stat. 281), relating to the taxation of banks on all dividends which they declared. The Suffolk bank had declared a dividend about three-tenths of which "consisted of profits laid aside before the passage of the first internal revenue law and the profits of sales of real estate bought before that time". On the remaining seven-tenths the Bank had paid the dividend tax of five per cent. under the Act of 1864 (13 Stat., c. 184). It was held that the three-tenths was capital and not liable to assessment as income. Judge Lowell said:

"As to the three-tenths it seems to me to have been a division of capital, a return to the plaintiffs in money of a part of the property which was already in their ownership as capital stock when the first tax act was passed. If the Suffolk bank had been wholly wound up, and had returned to its stockholders the exact value of their shares in money, having made no profits since the passage of the original act, this sum of money could not be taxed as income, gains, or profits; and so of a part. If the plaintiffs on

receiving the money chose to divide it among their own stockholders, still it is not a dividend out of gains and profits, nor out of the surplus funds, because the surplus funds that are taxable, are those which are or have been made out of profits, since the passage of the act" (p. 448).

In the second *Bailey* case (*Bailey v. Railroad Company*, 106 U. S. 109) the question concerned the dividend tax under Section 122 of the Act of June 30, 1864 (13 Stat., c. 184) which (*supra*, p. 35) covered "dividends in scrip", the tax on which was payable by the Railroad Company. It had been held in the first *Bailey* case (22 Wall. 604) that the certificates which had been issued were within this provision. These certificates were based on surplus earnings of the New York Central Railroad Company which had accrued during a period of fifteen years from 1853 to 1868. Only six years were covered by the Income Tax Law which first took effect in September, 1862 (12 Stat. 473). The Collector had assessed the tax upon the entire amount of the surplus represented by the certificates and the suit was brought to recover the amount of the tax as illegally exacted. The Court held that the precise question was not concluded by the former decision and that the tax was only payable with respect to the earnings which had accrued from September 1, 1862, when the first Income Tax Law took effect, to December 19, 1868. The Court said:

"It should be borne in mind, in the first place, that the tax provided for in this section is an

annual income tax, and its subject is the interest paid and profits earned by the company for each year, and year by year; and that both by the express letter of the law, and its necessary implications, the tax is not laid on any of these funds which came into being before the time prescribed in the act. And in the ordinary execution of the law, it was contemplated that the funds to be taxed, and the tax imposed upon them, would be concurrent, as to each fiscal year; the scheme of the statute being to levy the tax upon the income for the year ending on the 31st of December next preceding the assessment; and while it would be altogether admissible to go back, for the purpose of assessing a tax upon a proper fund which had accrued during a previous year and escaped taxation, nevertheless the tax imposed would be for the omitted year. But no tax, in contemplation of the law, accrues upon the fund, except for the year in which the fund itself accrued" (p. 114).

This decision was followed in *People vs. The Albany Insurance Company*, 92 N. Y. 458, 462, where it was held that the statutes in New York, providing for the taxation of the franchises of certain corporations, were prospective in character. There, the defendant corporation had on hand a large surplus fund which had been earned before the Tax Law took effect and it was subsequently divided among its stockholders. It was held that this division "even if a dividend within the letter was not such within the meaning or for the pur-

poses of the Act". The corporation accordingly was held not to be liable. The Court said:

"The surplus here in question was all acquired prior to the passage even of the act of 1880, and was the accumulation of earnings of several previous years. It had constituted part of the property of the corporation, and been taxable as such, during those years. It might have been the measure of the enjoyment of the franchise during those previous years when the franchise was not taxable, but was no measure of the value of such enjoyment during the year 1880 or 1881, and these aggregated earnings of several years were certainly no criterion of the value of such franchise during any single year. A division of property thus previously acquired could not have been within the contemplation of the framers of the act, in fixing upon the annual dividends as a measure of the value of the franchise of the corporation, and even if a dividend within the letter of the act, to construe it as a dividend for the purposes of the act would be so contrary to its spirit and intent, that such a construction is inadmissible.

"The decision of the Supreme Court of the United States in *Bailey v. Railroad Co.* (106 U. S. 109) is very much in point."

In the present case, in no proper sense was there income "arising or accruing" to the plaintiff after March 1, 1913. The capitalization of the surplus previously accumulated was not income to the plaintiff,

and his property interest in the accumulations antedated the effective date fixed by the tax law.

We have no desire to detract in the slightest degree from the proper operation of the Income Tax Laws. The Government is in no danger from inability either to create or to enforce proper demands upon stockholders. But this attempted charge upon stockholders with respect to their interests in the large surplus accumulations which had been effected prior to March 1st, 1913, under the pretext that their capitalization constituted income arising or accruing in the specified period, is a most serious oppression of the citizen and we believe it to be wholly unwarranted by the law.

We may refer briefly to recent decisions in the Federal Courts.

The case of *Gauley Mountain Coal Company v. Hays* (C. C. A. Fourth Circuit), 230 Fed. 110, arose under the Corporation Tax Act of 1909. The plaintiff corporation in 1902 purchased stock in another corporation which it sold in 1911 at an advance of \$210,000. Following *Gray v. Darlington* (*supra*), the Court declined to hold that the portion of its profit, in proportion to the time elapsing between the taking effect of the statute and the sale of the stock should be treated as "income" taxable for the year in which the sale was made.

Doyle v. Mitchell (C. C. A. Sixth Circuit), 235 Fed. 686, arose under the same Act. The plaintiff corporation owned timber lands which at the time the Act

went into effect had greatly increased in value. The company revalued its land as of December 31, 1908, and entered it on the books at its real value, though it had previously been carried at the original valuation. It was held that with respect to the tax for 1909 it was entitled to deduct the actual value of the land, as it stood on December 31, 1908. The Court said:

"The insistence of the Commissioner that this \$20 per acre appreciation is income for the year in which the timber happens to be cut rests at last upon the theory that the tax-payer is estopped to claim that it was income for an earlier period because he had not so entered it on his books; and this theory we cannot accept; its formal transfer into surplus or undivided profits account would have done nobody any good or any harm" (p. 692).

In *Cleveland & C. C. & St. L. Ry. Co. v. United States* (C. C. A. Sixth Circuit), 242 Fed. 18, another case under the Act of 1909, it appeared that the company had purchased 30,000 shares of Chesapeake & Ohio stock in 1900 and had sold the stock on January 28, 1909, at a large profit. The stock had a fixed market value on December 31st, 1908. The company did not include any portion of this profit in its return for the year 1909 and the Government brought suit to recover the tax and succeeded in the lower court. The Circuit Court of Appeals reversed the judgment except as to so much of the profit as was represented by the increase in value between January 1, 1909 and January 28, 1909.

The Court, referring to its decisions in *Doyle v. Mitchell* (*supra*) and *Biwabik Mining Co. v. United States*, 242 Fed. 9, said:

"In those cases we have given the reasons for our conclusion that the sum received during 1909 for capital assets sold during that year cannot be considered as income under this Act, excepting to the extent by which it exceeds the ascertained market value of those assets on January 1st of that year. The principles discussed and adopted in these cases necessarily lead to the reversal of this judgment, excepting with regard to the increased value which accrued after January 1st."

The case of *Lynch v. Turrish* (C. C. A. Eighth Circuit), 236 Fed. 653, arose under the Income Tax Law of October 3, 1913, and the question related to the income of a stockholder. It appeared that the Payette Lumber & Manufacturing Company of which Turrish was a stockholder, had invested prior to March 1, 1913, in timber lands. The value of its assets on that date was not less than \$3,000,000. There had been a gradual increase in the value of the timber lands from the time of their acquisition in 1903, and on March 1, 1913, Turrish's stock was worth twice its par value. In December, 1913, the property was sold to a new corporation, the Boise-Payette Company for \$3,000,000 in cash and transfer was consummated in March, 1914. The Payette Company then distributed the \$3,000,000 among its stockholders who surrendered their stock and Mr. Turrish received \$159,950, which was twice

the par value of his stock. The Commissioner of Internal Revenue deemed one-half of this sum to be capital and the other one-half to be income derived by him in 1914 from the dividend then received, and assessed an additional income tax accordingly which Turrish paid under protest and sued to recover back.

The Court sustained his recovery, holding that the distribution was not income. The Court, by Sanborn, J., said:

"All the value of the property of the corporation and all the value of the stock of the plaintiff, whether it was due to capital assets, or income, or gains, or profits, or all of these combined, had arisen and accrued and had become their property before March 1, 1913. . . . The provisions of this law" (referring to the provisions as to the period for which the tax should be levied) "leave no doubt that the Congress intended to and did exclude from the burdens of the taxes it imposed by the Income Tax Act of October 3, 1913, all income, gains, and profits of every kind which had arisen or accrued prior to March 1, 1913. It clearly intended to leave, and surely did leave, all the income, gains, and profits which had accrued or arisen prior to that date, whether they were in the form of divided or undivided surplus, income, gains, or profits, as free from every income tax it imposed, and as absolutely the property of their respective legal and equitable owners, as was any of their original capital or property. Now the subsequent change, by sale, distribution, or otherwise,

of the form of property held on March 1, 1913, without thereby enhancing its value, or causing any gain, profit, or income to its holders, as from real to personal property, or from stock to cash, does not subject it to the income tax, because it produces no gain, profit, or income; it leaves the value of the property the same after as before the change. And as the sale of the property of the Payette Company in 1914 and the distribution of its proceeds to its stockholders by the dividend did not enhance the value of the property of the corporation or of the stockholders, or produce any gain, profit, or income for them, but left the value of their property the same that it was before those transactions, and the same as it was when the Income Tax Law took effect, the declaration and payment in 1914 of the dividend by which the proceeds of the sale of the property of the corporation were distributed to its stockholders did not transform the increased value of the plaintiff's stock, which had accrued and arisen prior to March 1, 1913, into income, gains, or profits accruing or arising subsequent to that date and did not subject it to any income tax" (p. 657).

See also

Lynch v. Hornby, 236 Fed. 661.

The case of *Southern Pacific Co. v. Lowe*, 238 Fed. 847, involved certain extraordinary cash dividends received in 1914 which were held to be taxable and proceeded upon the ground that the dividends were cash

dividends paid out of corporate earnings which by the distribution became the individual property of the stockholder.

This question with respect to extraordinary cash dividends paid out of surplus accumulations existing before March 1, 1913, which are received by the stockholders as their separate property, is not involved in the present case and we are not concerned with the difference of judicial opinion in this class of cases. (*Southern Pacific Co. v. Lowe, supra*; *Gulf Oil Corporation v. Llewellyn*, 242 Fed. 709; s. c., C. C. A., Third Circuit; decided Oct. 8, 1917.) In the present case the stockholder has not received any portion of the corporate assets. What he will ultimately realize upon the stock in question no one can tell. The stock simply represents an interest in assets which existed on March 1, 1913, no part of which has become the plaintiff's separate property.

The District Judge apparently relied upon the decision of the Wisconsin Court in *Van Dyke v. Wisconsin*, 159 Wis. 460, in construing the Income Tax Law of that State. That act went into effect on January 1, 1911, and the question was whether dividends declared and distributed during 1911 out of surplus on hand prior to January first were taxable as income of that year; and the court, construing the State law, held that they were so taxable.

In the later case of *Bundy v. Nygaard*, 163 Wis. 307, the Company had accumulated a surplus prior to

January 1, 1911, and the stock was worth more than par. In 1914 the stockholder sold his stock at the 1911 price, that is, over par, and the court held that this sale did not create any income to him under the State law.

Subsequently the question that had been before the court in the *Van Dyke* case arose again in *State ex rel. Moon Co. v. Wisconsin Tax Commission*, 163 N. W. 639, and the attention of the Court was called to the decision of the Circuit Court of Appeals of the Eighth Circuit in *Lynch v. Turrish*, *supra*, where the *Van Dyke* case had been criticised. The Wisconsin court distinguished the *Lynch* case because of the "difference in the Acts" under which the two cases were decided. It was pointed out that under the Federal Act of 1913 it was necessary to find that the net income of Turrish was one "arising or accruing" after March 1, 1913, while under the Wisconsin Act the tax was imposed simply on "income received during the year" 1911 *et seq.* The Court said:

"Unlike the Federal Act there is no need to ascertain when the income arose or accrued in order to determine whether it is taxable. The fact that it was received during 1911 makes it taxable irrespective of when it arose or accrued. . . . Judge Sanborn was justified in saying in the *Lynch* case that the *Van Dyke* case was not controlling or persuasive, but that was because of the difference in the requirements of the Act under which the income tax was to be assessed" (p. 640).

4. Finally, when Congress undertook to tax 'stock dividends' it provided for the tax in express terms and excluded 'stock-dividends' based on surplus accumulations existing prior to March 1, 1913. (Act of September 8, 1916, 39 Stat. 756, see Appendix.)

The Act of September 8, 1916, provides as follows:

"Sec. 2. (a) That, . . . the net income of a taxable person shall include gains, profits and income . . . also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever: provided, *That the term 'dividends' as used in this title shall be held to mean any distribution made or ordered to be made by a corporation, joint-stock company, association, or insurance company, out of its earnings or profits accrued since March first, nineteen hundred and thirteen, and payable to its shareholders, whether in cash or in stock of the corporation, joint-stock company, association, or insurance company, which stock dividend shall be considered income, to the amount of its cash value.*"

The implication is unmistakable. The new provision is tantamount to a declaration that what was thus sought to be subjected to the tax had not been embraced in the prior law. And it demonstrates most clearly that Congress had never intended to tax 'stock dividends' based on earnings accrued before the Sixteenth Amendment went into effect, *or before March 1, 1913.*

Sarlls v. United States, 152 U. S. 570, 577.

Matthews v. McStea, 91 U. S. 7, 13.

Matter of Miller, 110 N. Y. 216, 222.

Matter of Harbeck, 161 N. Y. 211, 217, 218.

Lawrence v. People, 188 Ill. 407, 414.

Endlich on Interpretation of Statutes, Secs.

43, 44, 47.

In this connection there should also be noted the provision of subdivision (c) of Section 2 of the Act of 1916 (39 Stat. 758, see Appendix), viz.:

“For the purpose of ascertaining the gain derived from the sale or other disposition of property, real, personal, or mixed acquired before March first, nineteen hundred and thirteen, the fair market price or value of such property as of March first, nineteen hundred and thirteen, shall be the basis for determining the amount of such gain derived.”

See also Section 10 (39 Stat. 765).

Treating these acts as *in pari materia*, and reading them together (*United States v. Freeman*, 3 How. 556, 564, 560; *Tiger v. Western Investment Co.*, 221 U. S. 286, 306) and giving proper weight to the provision of the Act of 1913, that the income to be taxed for the year 1913, must be that “arising or accruing” after March 1, 1913, we think the conclusion is irresistible that Congress never intended to tax ‘stock dividends’ which merely represented the capitalization of surplus accumulations existing prior to that date.

We find further evidence in the War Revenue Act of October 3, 1917 (see Appendix). Even in raising revenue to meet the vast requirements of the War, Congress has not sought under the guise of a tax on "income" since March 1, 1913, to reach stock dividends based on previous accumulations. Congress, indeed, has endeavored to establish safeguards as to current surplus earnings, but those accumulations which existed before March 1, 1913, were to be, as before, inviolate.

Among the Income Tax Amendments made by the War Revenue Act of October 3, 1917, is the following (see Appendix):

"Sec. 31. (a) That the term 'dividends' as used in this title shall be held to mean any distribution made or ordered to be made by a corporation, joint-stock company, association, or insurance company, *out of its earnings or profits accrued since March first, nineteen hundred and thirteen*, and payable to its shareholders, whether in cash or in stock of the corporation, joint-stock company, association, or insurance company, which stock dividend shall be considered income, to the amount of the earnings or profits so distributed.

"(b) Any distribution made to the shareholders or members of a corporation, joint-stock company, or association, or insurance company, in the year nineteen hundred and seventeen, or subsequent tax years, shall be deemed to have been made from the most recently accumulated undivided profits or surplus, and shall constitute a part of the annual income of the distributee

for the year in which received, and shall be taxed to the distributee at the rates prescribed by law for the years in which such profits or surplus were accumulated by the corporation, joint-stock company, association, or insurance company, *but nothing herein shall be construed as taxing any earnings or profits accrued prior to March first, nineteen hundred and thirteen, but such earnings or profits may be distributed in stock dividends or otherwise, exempt from the tax*, after the distribution of earnings and profits accrued since March first, nineteen hundred and thirteen, has been made. This subdivision shall not apply to any distribution made prior to August sixth, nineteen hundred and seventeen, out of earnings or profits accrued prior to March first, nineteen hundred and thirteen."

It is plain that the concluding sentence of subdivision (b) does not mean that 'stock dividends' if made before August 6, 1917, were to be taxable although based on earnings before March 1, 1913, for these had not been taxable under the express language of the Act of 1916, and the Act of 1917 was not passed until long after August sixth of that year. What is meant is that the rule of subdivision (b), that "distribution" shall be "deemed to have been made from the most recently accumulated" surplus, should not apply where in fact the "distribution" had been made "out of earnings or profits" accrued before March 1, 1913, and it had taken place before August 6, 1917.

Thereafter, or at least after the passage of the Act, "the most recently accumulated surplus" was to be first "distributed", but in *no event* was any tax to be laid on "*any earnings or profits accrued*" prior to March 1, 1913.

**IT IS SUBMITTED THAT THE JUDGMENT OF THE
DISTRICT COURT SHOULD BE REVERSED.**

CHARLES E. HUGHES,
GEORGE WELWOOD MURRAY,
CHARLES P. HOWLAND,
LOUIS H. PORTER,
Counsel for the Plaintiff-in-Error.

APPENDIX.

Act of October 3, 1913, 38 Stat. 114, 116, Paragraphs A-D
Inclusive.

SECTION II.

A. Subdivision 1. That there shall be levied, assessed, collected and paid annually upon the entire net income arising or accruing from all sources in the preceding calendar year to every citizen of the United States, whether residing at home or abroad, and to every person residing in the United States, though not a citizen thereof, a tax of 1 per centum per annum upon such income, except as hereinafter provided; and a like tax shall be assessed, levied, collected, and paid annually upon the entire net income from all property owned and of every business, trade, or profession carried on in the United States by persons residing elsewhere.

Subdivision 2. In addition to the income tax provided under this section (herein referred to as the normal income tax) there shall be levied, assessed, and collected upon the net income of every individual an additional income tax (herein referred to as the additional tax) of 1 per centum per annum upon the amount by which the total net income exceeds \$20,000 and does not exceed \$50,000, and 2 per centum per annum upon the amount by which the total net income exceeds \$50,000 and does not exceed \$75,000, 3 per centum per annum upon the amount by which the total net income exceeds \$75,000 and does not exceed \$100,000, 4 per centum per annum upon the amount by which the total net income exceeds \$100,000 and does not exceed \$250,000, 5 per centum per annum upon the amount by which the total net income exceeds \$250,000 and does not exceed \$500,000, and 6 per centum per annum upon the amount by which the total net income exceeds \$500,000. All the provisions of this section relating to individuals who are to be chargeable with the normal income tax, so far as they are applicable and are not inconsistent with this subdivision of paragraph A, shall

apply to the levy, assessment, and collection of the additional tax imposed under this section. Every person subject to this additional tax shall, for the purpose of its assessment and collection, make a personal return of his total net income from all sources, corporate or otherwise, for the preceding calendar year, under rules and regulations to be prescribed by the Commissioner of Internal Revenue and approved by the Secretary of the Treasury. For the purpose of this additional tax the taxable income of any individual shall embrace the share to which he would be entitled of the gains and profits, if divided or distributed, whether divided or distributed or not, of all corporations, joint-stock companies, or associations however created or organized, formed or fraudulently availed of for the purpose of preventing the imposition of such tax through the medium of permitting such gains and profits to accumulate instead of being divided or distributed; and the fact that any such corporation, joint-stock company, or association, is a mere holding company, or that the gains and profits are permitted to accumulate beyond the reasonable needs of the business shall be prima facie evidence of a fraudulent purpose to escape such tax; but the fact that the gains and profits are in any case permitted to accumulate and become surplus shall not be construed as evidence of a purpose to escape the said tax in such case unless the Secretary of the Treasury shall certify that in his opinion such accumulation is unreasonable for the purposes of the business. When requested by the Commissioner of Internal Revenue, or any district collector of internal revenue, such corporation, joint-stock company, or association shall forward to him a correct statement of such profits and the names of the individuals who would be entitled to the same if distributed.

B. That, subject only to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shall include gains, profits, and income derived from salaries, wages, or compensation for personal service of whatever kind and in whatever form

paid, or from professions, vocations, businesses, trade, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property, also from interest, rent, dividends, securities, or the transaction of any lawful business carried on for gain or profit, or gains or profits and income derived from any source whatever, including the income from but not the value of property acquired by gift, bequest, devise, or descent: *Provided*, That the proceeds of life insurance policies paid upon the death of the person insured or payments made by or credited to the insured, on life insurance, endowment, or annuity contracts, upon the return thereof to the insured at the maturity of the term mentioned in the contract, or upon surrender of contract, shall not be included as income.

That in computing net income for the purpose of the normal tax there shall be allowed as deductions: First, the necessary expenses actually paid in carrying on any business, not including personal, living, or family expenses; second, all interest paid within the year by a taxable person on indebtedness; third, all national, State, county, school, and municipal taxes paid within the year, not including those assessed against local benefits; fourth, losses actually sustained during the year, incurred in trade or arising from fires, storms, or shipwreck, and not compensated for by insurance or otherwise; fifth, debts due to the taxpayer actually ascertained to be worthless and charged off within the year; sixth, a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business, not to exceed, in the case of mines, 5 per centum of the gross value at the mine of the output for the year for which the computation is made, but no deduction shall be made for any amount of expense of restoring property or making good the exhaustion thereof for which an allowance is or has been made: *Provided*, That no deduction shall be allowed for any amount paid out

for new buildings, permanent improvements, or betterments, made to increase the value of any property or estate; seventh, the amount received as dividends upon the stock or from the net earnings of any corporation, joint stock company, association, or insurance company which is taxable upon its net income as hereinafter provided; eighth, the amount of income, the tax upon which has been paid or withheld for payment at the source of the income, under the provisions of this section, provided that whenever the tax upon the income of a person is required to be withheld and paid at the source as hereinafter required, if such annual income does not exceed the sum of \$3,000 or is not fixed or certain, or is indefinite, or irregular as to amount or time of accrual, the same shall not be deducted in the personal return of such person.

The net income from property owned and business carried on in the United States by persons residing elsewhere shall be computed upon the basis prescribed in this paragraph and that part of paragraph G of this section relating to the computation of the net income of corporations, joint-stock and insurance companies, organized, created, or existing under the laws of foreign countries, in so far as applicable.

That in computing net income under this section there shall be excluded the interest upon the obligations of a State or any political subdivision thereof, and upon the obligations of the United States or its possessions; also the compensation of the present President of the United States during the term for which he has been elected, and of the judges of the supreme and inferior courts of the United States now in office, and the compensation of all officers and employees of a State or any political subdivision thereof except when such compensation is paid by the United States Government.

C. That there shall be deducted from the amount of the net income of each of said persons, ascertained as provided herein, the sum of \$3,000, plus \$1,000

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additional if the person making the return be a married man with a wife living with him, or plus the sum of \$1,000 additional if the person making the return be a married woman with a husband living with her; but in no event shall this additional exemption of \$1,000 be deducted by both a husband and a wife: *Provided*, That only one deduction of \$4,000 shall be made from the aggregate income of both husband and wife when living together.

D. The said tax shall be computed upon the remainder of said net income of each person subject thereto, accruing during each preceding calendar year ending December thirty-first: *Provided, however*, That for the year ending December thirty-first, nineteen hundred and thirteen, said tax shall be computed on the net income accruing from March first to December thirty-first, nineteen hundred and thirteen, both dates inclusive, after deducting five-sixths only of the specific exemptions and deductions herein provided for. On or before the first day of March, nineteen hundred and fourteen, and the first day of March in each year thereafter, a true and accurate return, under oath or affirmation, shall be made by each person of lawful age, except as hereinafter provided, subject to the tax imposed by this section, and having a net income of \$3,000 or over for the taxable year, to the collector of internal revenue for the district in which such person resides or has his principal place of business, or, in the case of a person residing in a foreign country, in the place where his principal business is carried on within the United States, in such form as the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, shall prescribe, setting forth specifically the gross amount of income from all separate sources and from the total thereof, deducting the aggregate items or expenses and allowance herein authorized; guardians, trustees, executors, administrators, agents, receivers, conservators, and all persons, corporations, or associations acting in any fiduciary

capacity, shall make and render a return of the net income of the person for whom they act, subject to this tax, coming into their custody or control and management, and be subject to all the provisions of this section which apply to individuals: *Provided*, That a return made by one of two or more joint guardians, trustees, executors, administrators, agents, receivers, and conservators, or other persons acting in a fiduciary capacity, filed in the district where such person resides, or in the district where the will or other instrument under which he acts is recorded, under such regulations as the Secretary of the Treasury may prescribe, shall be a sufficient compliance with the requirements of this paragraph; and also all persons, firms, companies, copartnerships, corporations, joint-stock companies or associations, and insurance companies, except as hereinafter provided, in whatever capacity acting, having the control, receipt, disposal, or payment of fixed or determinable annual or periodical gains, profits, and income of another person subject to tax, shall in behalf of such person deduct and withhold from the payment an amount equivalent to the normal income tax upon the same and make and render a return, as aforesaid, but separate and distinct, of the portion of the income of each person from which the normal tax has been thus withheld, and containing also the name and address of such person or stating that the name and address or the address, as the case may be, are unknown: *Provided*, That the provision requiring the normal tax of individuals to be withheld at the source of the income shall not be construed to require any of such tax to be withheld prior to the first day of November, nineteen hundred and thirteen: *Provided further*, That in either case above mentioned no return of income not exceeding \$3,000 shall be required: *Provided further*, That any persons carrying on business in partnership shall be liable for income tax only in their individual capacity, and the share of the profits of a partnership to which any taxable partner would

be entitled if the same were divided, whether divided or otherwise, shall be returned for taxation and the tax paid, under the provisions of this section, and any such firm, when requested by the Commissioner of Internal Revenue, or any district collector, shall forward to him a correct statement of such profits and the names of the individuals who would be entitled to the same, if distributed: *Provided further*, That persons liable for the normal income tax only, on their own account or in behalf of another, shall not be required to make return of the income derived from dividends on the capital stock or from the net earnings of corporations, joint-stock companies or associations, and insurance companies taxable upon their net income as hereinafter provided. Any person for whom return has been made and the tax paid, or to be paid as aforesaid, shall not be required to make a return unless such person has other net income, but only one deduction of \$3,000 shall be made in the case of any such person. The collector or deputy collector shall require every list to be verified by the oath or affirmation of the party rendering it. If the collector or deputy collector have reason to believe that the amount of any income returned is understated, he shall give due notice to the person making the return to show cause why the amount of the return should not be increased, and upon proof of the amount understated may increase the same accordingly. If dissatisfied with the decision of the collector, such person may submit the case, with all the papers, to the Commissioner of Internal Revenue for his decision, and may furnish sworn testimony of witnesses to prove any relevant facts.

Act of September 8, 1916, Stat. 1915-16, p. 756, Sections 1-5
Inclusive.

TITLE I.—INCOME TAX.

PART I.—ON INDIVIDUALS.

SEC. 1. (a) That there shall be levied, assessed, collected, and paid annually upon the entire net income received in the preceding calendar year from all sources by every individual, a citizen or resident of the United States, a tax of two per centum upon such income; and a like tax shall be levied, assessed, collected, and paid annually upon the entire net income received in the preceding calendar year from all sources within the United States by every individual, a nonresident alien, including interest on bonds, notes, or other interest-bearing obligations of residents, corporate or otherwise.

(b) In addition to the income tax imposed by subdivision (a) of this section (herein referred to as the normal tax) there shall be levied, assessed, collected, and paid upon the total net income of every individual, or, in the case of a nonresident alien, the total net income received from all sources within the United States, an additional income tax (herein referred to as the additional tax) of one per centum per annum upon the amount by which such total net income exceeds \$20,000 and does not exceed \$40,000, two per centum per annum upon the amount by which such total net income exceeds \$40,000 and does not exceed \$60,000, three per centum per annum upon the amount by which such total net income exceeds \$60,000 and does not exceed \$80,000, four per centum per annum upon the amount by which such total net income exceeds \$80,000 and does not exceed \$100,000, five per centum per annum upon the amount by which such total net income exceeds \$100,000 and does not exceed \$150,000, six per centum per annum upon the amount by which such total net income exceeds \$150,000 and does not exceed \$200,000, seven per centum per annum upon the amount by which such total net income exceeds \$200,000 and does not

exceed \$250,000, eight per centum per annum upon the amount by which such total net income exceeds \$250,000 and does not exceed \$300,000, nine per centum per annum upon the amount by which such total net income exceeds \$300,000 and does not exceed \$500,000, ten per centum per annum upon the amount by which such total net income exceeds \$500,000, and does not exceed \$1,000,000, eleven per centum per annum upon the amount by which such total net income exceeds \$1,000,000 and does not exceed \$1,500,000, twelve per centum per annum upon the amount by which such total net income exceeds \$1,500,000 and does not exceed \$2,000,000, and thirteen per centum per annum upon the amount by which such total net income exceeds \$2,000,000.

For the purpose of the additional tax there shall be included as income the income derived from dividends on the capital stock or from the net earnings of any corporation, joint-stock company or association, or insurance company, except that in the case of non-resident aliens such income derived from sources without the United States shall not be included.

All the provisions of this title relating to the normal tax on individuals, so far as they are applicable and are not inconsistent with this subdivision and section three, shall apply to the imposition, levy, assessment, and collection of the additional tax imposed under this subdivision.

(c) The foregoing normal and additional tax rates shall apply to the entire net income, except as hereinafter provided, received by every taxable person in the calendar year nineteen hundred and sixteen and in each calendar year thereafter.

INCOME DEFINED.

SEC. 2. (a) That, subject only to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shall include gains, profits, and

income derived from salaries, wages, or compensation for personal service of whatever kind and in whatever form paid, or from professions, vocations, businesses, trade, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property, also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever: *Provided*, That the term "dividends" as used in this title shall be held to mean any distribution made or ordered to be made by a corporation, joint-stock company, association, or insurance company, out of its earnings or profits accrued since March first, nineteen hundred and thirteen, and payable to its shareholders, whether in cash or in stock of the corporation, joint-stock company, association, or insurance company, which stock dividend shall be considered income, to the amount of its cash value.

(b) Income received by estates of deceased persons during the period of administration or settlement of the estate, shall be subject to the normal and additional tax and taxed to their estates, and also such income of estates or any kind of property held in trust, including such income accumulated in trust for the benefit of unborn or unascertained persons, or persons with contingent interests, and income held for future distribution under the terms of the will or trust shall be likewise taxed, the tax in each instance, except when the income is returned for the purpose of the tax by the beneficiary, to be assessed to the executor, administrator, or trustee, as the case may be: *Provided*, That where the income is to be distributed annually or regularly between existing heirs or legatees, or beneficiaries the rate of tax and method of computing the same shall be based in each case upon the amount of the individual share to be distributed.

Such trustees, executors, administrators, and other fiduciaries are hereby indemnified against the claims or

demands of every beneficiary for all payments of taxes which they shall be required to make under the provisions of this title, and they shall have credit for the amount of such payments against the beneficiary or principal in any accounting which they make as such trustees or other fiduciaries.

(c) For the purpose of ascertaining the gain derived from the sale or other disposition of property, real, personal, or mixed, acquired before March first, nineteen hundred and thirteen, the fair market price or value of such property as of March first, nineteen hundred and thirteen, shall be the basis for determining the amount of such gain derived.

ADDITIONAL TAX INCLUDES UNDISTRIBUTED PROFITS.

SEC. 3. For the purpose of the additional tax, the taxable income of any individual shall include the share to which he would be entitled of the gains and profits, if divided or distributed, whether divided or distributed or not, of all corporations, joint-stock companies or associations, or insurance companies, however created or organized, formed or fraudulently availed of for the purpose of preventing the imposition of such tax through the medium of permitting such gains and profits to accumulate instead of being divided or distributed; and the fact that any such corporation, joint-stock company or association, or insurance company is a mere holding company, or that the gains and profits are permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a fraudulent purpose to escape such tax; but the fact that the gains and profits are in any case permitted to accumulate and become surplus shall not be construed as evidence of a purpose to escape the said tax in such case unless the Secretary of the Treasury shall certify that in his opinion such accumulation is unreasonable for the purposes of the business. When requested by the Commissioner of Internal Revenue, or any district

collector of internal revenue, such corporation, joint-stock company or association, or insurance company shall forward to him a correct statement of such gains and profits and the names and addresses of the individuals or shareholders who would be entitled to the same if divided or distributed.

INCOME EXEMPT FROM LAW.

SEC. 4. The following income shall be exempt from the provisions of this title:

The proceeds of life insurance policies paid to individuals beneficiaries upon the death of the insured; the amount received by the insured, as a return of premium or premiums paid by him under life insurance, endowment, or annuity contracts, either during the term or at the maturity of the term mentioned in the contract or upon the surrender of the contract; the value of property acquired by gift, bequest, devise, or descent (but the income from such property shall be included as income); interest upon the obligations of a State or any political subdivision thereof or upon the obligations of the United States or its possessions or securities issued under the provisions of the Federal farm loan Act of July seventeenth, nineteen hundred and sixteen; the compensation of the present President of the United States during the term for which he has been elected, and the judges of the Supreme and inferior courts of the United States now in office, and the compensation of all officers and employees of a State, or any political subdivision thereof, except when such compensation is paid by the United States Government.

DEDUCTIONS ALLOWED.

SEC. 5. That in computing net income in the case of a citizen or resident of the United States—

(a) For the purpose of the tax there shall be allowed as deductions—

First. The necessary expenses actually paid in carrying on any business or trade, not including personal, living, or family expenses;

Second. All interest paid within the year on his indebtedness;

Third. Taxes paid within the year imposed by the authority of the United States, or its Territories, or possessions, or any foreign country, or under the authority of any State, county, school district, or municipality, or other taxing subdivision of any State, not including those assessed against local benefits;

Fourth. Losses actually sustained during the year, incurred in his business or trade, or arising from fires, storms, shipwreck, or other casualty, and from theft, when such losses are not compensated for by insurance or otherwise: *Provided*, That for the purpose of ascertaining the loss sustained from the sale or other disposition of property, real, personal, or mixed, acquired before March first, nineteen hundred and thirteen, the fair market price or value of such property as of March first, nineteen hundred and thirteen, shall be the basis for determining the amount of such loss sustained;

Fifth. In transactions entered into for profit but not connected with his business or trade, the losses actually sustained therein during the year to an amount not exceeding the profits arising therefrom;

Sixth. Debts due to the taxpayer actually ascertained to be worthless and charged off within the year;

Seventh. A reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business or trade;

Eighth. (a) In the case of oil and gas wells a reasonable allowance for actual reduction in flow and production to be ascertained not by the flush flow, but by the settled production or regular flow; (b) in the

case of mines a reasonable allowance for depletion thereof not to exceed the market value in the mine of the product thereof, which has been mined and sold during the year for which the return and computation are made, such reasonable allowance to be made in the case of both (a) and (b) under rules and regulations to be prescribed by the Secretary of the Treasury: *Provided*, That when the allowances authorized in (a) and (b) shall equal the capital originally invested, or in case of purchase made prior to March first, nineteen hundred and thirteen, the fair market value as of that date, no further allowance shall be made. No deduction shall be allowed for any amount paid out for new buildings, permanent improvements, or betterments, made to increase the value of any property or estate, and no deduction shall be made for any amount of expense of restoring property or making good the exhaustion thereof for which an allowance is or has been made.

CREDITS ALLOWED.

(b) For the purpose of the normal tax only, the income embraced in a personal return shall be credited with the amount received as dividends upon the stock or from the net earnings of any corporation, joint-stock company or association, trustee, or insurance company, which is taxable upon its net income as hereinafter provided;

(c) A like credit shall be allowed as to the amount of income, the normal tax upon which has been paid or withheld for payment at the source of the income under the provisions of this title.

War Revenue Act of October 3, 1917, Sections 1200, 1201, 1211.

TITLE XII.—INCOME TAX AMENDMENTS.

SEC. 1200. That subdivision (a) of section two of such Act of September eighth, nineteen hundred and sixteen, is hereby amended to read as follows:

“(a) That, subject only to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shall include gains, profits, and income, derived from salaries, wages, or compensation for personal service of whatever kind and in whatever form paid, or from professions, vocations, businesses, trade, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property, also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever.

Section four of such Act of September eighth, nineteen hundred and sixteen, is hereby amended to read as follows:

“SEC. 4. The following income shall be exempt from the provisions of this title:

“The proceeds of life insurance policies paid to individual beneficiaries upon the death of the insured; the amount received by the insured, as a return of premium or premiums paid by him under life insurance, endowment, or annuity contracts, either during the term or at the maturity of the term mentioned in the contract or upon surrender of the contract; the value of property acquired by gift, bequest, devise, or descent (but the income from such property shall be included as income); interest upon the obligations of a State or any political subdivision thereof or upon the obligations of the United States (but, in the case of obligations of the United States issued after September first, nineteen hundred and seventeen, only if and

to the extent provided in the act authorizing the issue thereof) or its possessions or securities issued under the provisions of the Federal Farm Loan Act of July seventeenth, nineteen hundred and sixteen; the compensation of the present President of the United States during the term for which he has been elected and the judges of the supreme and inferior courts of the United States now in office, and the compensation of all officers and employees of a State, or any political subdivision thereof, except when such compensation is paid by the United States Government."

SEC. 1201. (1) That paragraphs second and third of subdivision (a) of section five of such Act of September eighth, nineteen hundred and sixteen, are hereby amended to read as follows:

"Second. All interest paid within the year on his indebtedness except on indebtedness incurred for the purchase of obligations or securities the interest upon which is exempt from taxation as income under this title;

"Third. Taxes paid within the year imposed by the authority of the United States (except income and excess profits taxes) or of its Territories, or possessions, or any foreign country, or by the authority of any State, county, school district, or municipality, or other taxing subdivision of any State, not including those assessed against local benefits;"

(2) That section five of such Act of September eighth, nineteen hundred and sixteen, is hereby amended by adding at the end of subdivision (a) a further paragraph numbered nine, to read as follows:

"Ninth. Contributions or gifts actually made within the year to corporations or associations organized and operated exclusively for religious, charitable, scientific, or educational purposes, or to societies for the prevention of cruelty to children or animals, no

part of the net income of which inures to the benefit of any private stockholder or individual, to an amount not in excess of fifteen per centum of the taxpayers' taxable net income as computed without the benefit of this paragraph. Such contributions or gifts shall be allowable as deductions only if verified under rules and regulations prescribed by the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury."

SEC. 1211. That Title I of such Act of September eighth, nineteen hundred and sixteen, is hereby amended by adding to Part III six new sections, as follows:

"SEC. 31. (a) That the term 'dividends' as used in this title shall be held to mean any distribution made or ordered to be made by a corporation, joint-stock company, association, or insurance company, out of its earning or profits accrued since March first, nineteen hundred and thirteen, and payable to its shareholders, whether in cash or in stock of the corporation, joint-stock company, association, or insurance company, which stock dividend shall be considered income, to the amount of the earning or profits so distributed.

"(b) Any distribution made to the shareholders or members of a corporation, joint-stock company, or association, or insurance company, in the year nineteen hundred and seventeen, or subsequent tax years, shall be deemed to have been made from the most recently accumulated undivided profits or surplus, and shall constitute a part of the annual income of the distributee for the year in which received, and shall be taxed to the distributee at the rates prescribed by law for the years in which such profits or surplus were accumulated by the corporation, joint-stock company, association, or insurance company, but nothing herein shall be construed as taxing any earning or profits

accrued prior to March first, nineteen hundred and thirteen, but such earnings or profits may be distributed in stock dividends or otherwise, exempt from the tax, after the distribution of earnings and profits accrued since March first, nineteen hundred and thirteen, has been made. This subdivision shall not apply to any distribution made prior to August sixth, nineteen hundred and seventeen, out of earnings or profits accrued prior to March first, nineteen hundred and thirteen.

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Supreme Court of the United States,

OCTOBER TERM, 1917.

No. 563.

HENRY R. TOWNE,

Petitioner in Error.

v.

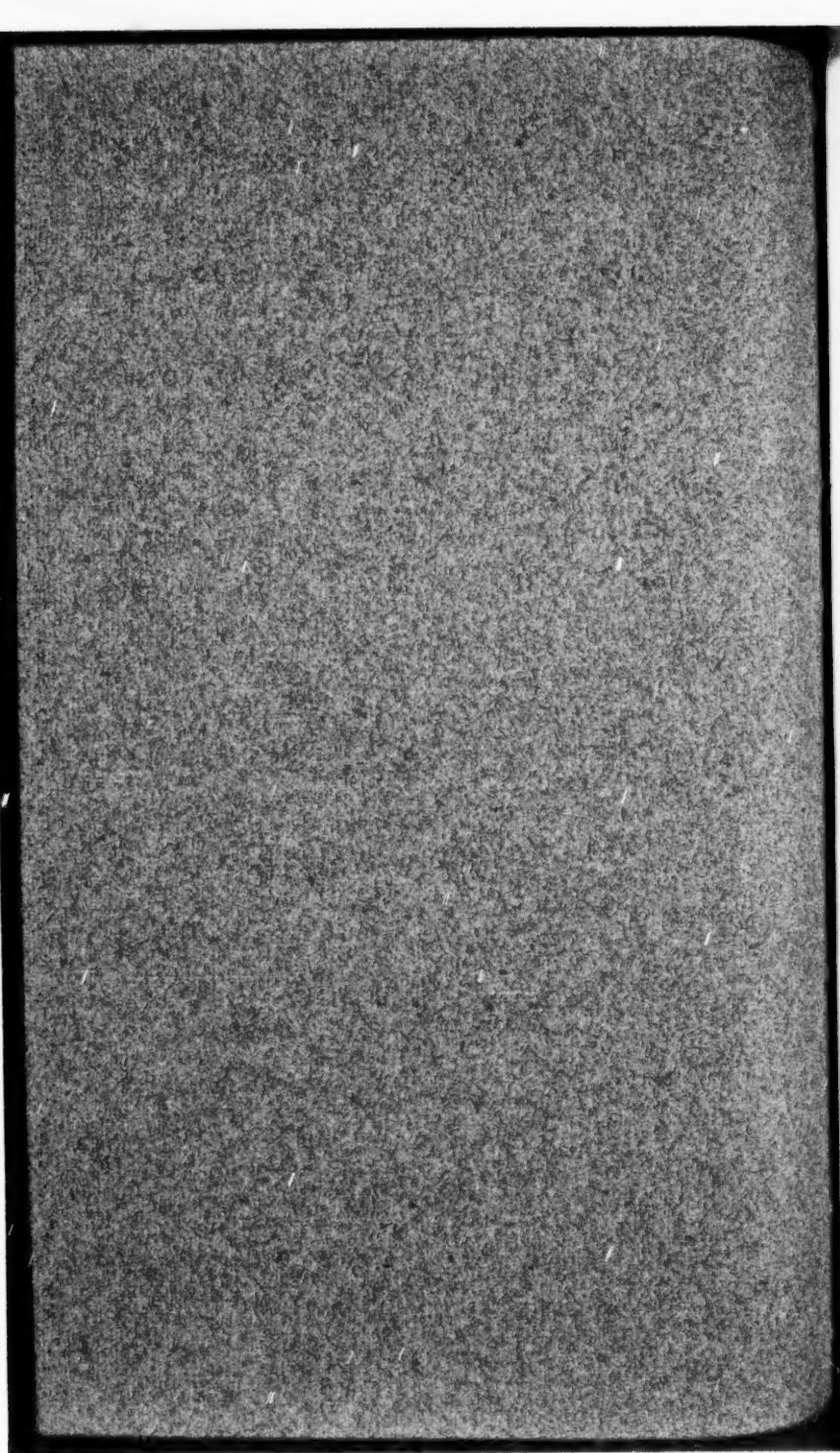
MARK EISNER, Collector, etc.

BRIEF

Constructing Income Tax Act of 1913 in respect
of dividends paid from surplus accrued prior
to the Sixteenth Amendment.

GORDON M. BUCK,

Amicus Curiae.



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Supreme Court of the United States,
OCTOBER TERM, 1917.

HENRY R. TOWNE,
Plaintiff in Error,

v.

MARK EISNER, Collector, Etc.,
Defendant in Error.

No. 563.

BRIEF

**Construing Income Tax Act of 1913 in
respect of Dividends paid from Sur-
plus Accrued prior to the Sixteenth
Amendment.**

The counsel who files this brief represents the plaintiff in error in the case of *Southern Pacific Company v. Lowe, Collector*, No. 452 on the present docket of this court. That case involves a tax levied on extraordinary cash dividends paid early in the year 1914 from a surplus accumulated many years before the adoption of the Sixteenth Amendment. The case at bar involves the question of a stock dividend representing the capitalization of a surplus accumulated prior to January 1, 1913. In both cases the tax was claimed to be

collected under the terms of the Income Tax Act of 1913 (hereinafter referred to as the "Act"). The learned counsel in this case have so convincingly argued that a stock dividend is not income, because it distributes nothing, and have also so thoroughly argued the constitutional questions involved, that they have not deemed it necessary to argue equally exhaustively the proposition that no dividend is taxable under the terms of the Act, if paid from a surplus that accrued prior to the adoption of the Sixteenth Amendment. This brief is concerned solely with the proposition that:

The Act by its terms should not be construed as imposing a tax on dividends paid from surplus accumulated prior to the adoption of the Sixteenth Amendment.

The importance of this question in its effect upon the government's revenue is destroyed by the amendments made to the Act in the years 1916 and 1917. As soon as Congress found that the Treasury officials were construing the Act as imposing a tax on dividends paid from surplus accrued prior to the Sixteenth Amendment, the Act was immediately amended to provide specifically that dividends paid from such surplus were not income within the meaning of the statute.

Income Tax Act of 1916, Secs. 2 and 10;
Income Tax Act of 1917, Sec. 1211.

This action strongly indicates the construction that Congress gave to the Act of 1913. In construing this Act we should bear in mind that—

(1) STATUTES IMPOSING TAXES MUST BE STRICTLY CONSTRUED AGAINST THE GOVERNMENT AND IN FAVOR OF THE TAXPAYER.

In *Gould v. Gould*, decided November 19, 1917, this court said, with regard to the Act (McREYNOLDS, J.):

“In the interpretation of statutes levying taxes it is the established rule not to extend their provisions, by implication, beyond the clear import of the language used, or to enlarge their operations so as to embrace matters not specifically pointed out. In case of doubt they are construed most strongly against the Government and in favor of the citizen.”

In *Eidman v. Martinez*, 184 U. S., 578, 583, the court said:

“It is an old and familiar rule of the English courts, applicable to all forms of taxation, and particularly special taxes, that the Sovereign is bound to express its intention to tax in clear and unambiguous language, and that a liberal construction be given to words of *exception* confining the operation of duty. * * *

“We have ourselves had repeated occasion to hold that the customs revenue laws should be liberally interpreted in favor of the im-

porter and that the intent of Congress to impose or increase a tax upon imports should be expressed in clear and unambiguous language."

Black on Income Taxes (2nd Ed.), Sec. 217, and cases cited.

(2) ANALYSIS OF THE ACT.

The statute subjects individuals to an income tax of one per cent. "upon the entire net income arising or accruing from all sources during the preceding calendar year" (Clause A, subd. 1). Such net income is defined as including "gains, profits and income" less deductions and exemptions (Clause B). A similar tax is imposed upon corporations in almost identical language [Clause G, subd. (a)]. It should be noted at the outset that the tax is laid not upon all receipts, but upon "*net income*."

(a) *Not all "income," in the sense of everything that comes in, is taxed; but only income that consists of gains or profits.*

The proper definition of the word "income," as it appears in the Act, was well stated by Senator John Sharp Williams, speaking in the Senate for the Committee that had charge of the bill. He said:

" 'Income' means the net gains or profits.
 * * * A man's taxable income means his gains and profits during the year. Those

gains and profits or income derived from any business of any description are taxed. If a man is engaged in dealing in horses, if he buys horses and sells horses and makes a profit or an income out of that dealing, he must pay a tax upon the income."

Cong. Rec., August 26, 1913, Vol. 50, No. 97, p. 4192.

He answered the suggestion that the word "income" might be held to mean receipts of every sort, as follows:

"The income within the contemplation of a tax law does not mean that. It means net income, and is so defined in the bill. That means profits or gains."

Id., p. 4192.

Senator Williams further stated that he saw no objection to striking out the word "income" altogether (*id.*, p. 4193).

The Act should not be construed to tax everything received by the person or corporation subject to tax; otherwise the words "gains" and "profits" are given no meaning. For, if "income" means everything that comes in, it is so comprehensive as necessarily to embrace all gains and profits. The true function of the words "gains" and "profits" is to limit the meaning of the word "income" and to show that the latter word was used only in the sense of receipts which constitute an accretion to capital.

Says Black on Income Taxes (2nd Edition), Sec. 219:

“If it is doubtful whether or not a particular fund or acquisition is taxable as ‘income,’ under the statute, it is not taxable unless it is income in the nature of ‘gain’ or ‘profit.’ ”

On the other hand, the function of the word “income” is to limit the meaning of the words “gains” and “profits.” The increased value of capital assets constitutes in one sense a gain or profit, but not income. Hence, such gain or profit is not taxable, but only such gains and profits as constitute income.

Gray v. Darlington, 15 Wall., 63;
Gauley Mountain Coal Company v. Hays,
 230 Fed., 110 (C. C. A.);
Doyle v. Mitchell, 235 Fed., 686 (C. C.
 A.);
Baldwin Locomotive Works v. McCoach,
 221 Fed., 59 (C. C. A.);
Industrial Trust Co. v. Walsh, 222 Fed.,
 437.

Income from capital has been accurately defined in *People v. Davenport*, 30 Hun, 177, 186, as “that which it earns, remaining itself intact.”

Thorn v. DeBreuteuil, 86 App. Div., 405,
 415.

On this subject, Foster on Income Tax, Sec. 46, says:

“By the rule of construction, *noscitur a sociis*, however, the words in this statute must be construed in connection with those to which it is joined, namely, gains and profits; and it is evidently the intention, as a general rule, to tax only the profits of the taxpayer, not his whole revenue. Accordingly, money received as the result of the change of an investment, or as the proceeds of a sale without profit, is not income. Thus, when a vendor received the purchase-money in annual installments, it was held in England that such installments were principal and not taxable as ‘annual payments’ or income. So, too, an increase of capital when realized cannot justly be called profit or income. Examples are the increase in the value of real estate, or personal property, such as stocks, unless expressly provided in the statute. ‘Mere advance in value in no sense constitutes the gains, profits, or income specified by the statute. It constitutes and can be treated merely as increase of capital.’ ”

In *Lawless v. Sullivan*, L. R., 6 App. Cas., 373, a case involving the construction of the British income tax act, the Privy Council, speaking through Sir Montague E. Smith, said:

“It was not and could not be contended on behalf of the assessors that ‘income’ in the enactment meant all the takings or moneys received by a bank or in a trade from customers or otherwise; and it was not denied that it meant profits, in some sense of the word.”

So the Act specifically provides that payments returned by insurance companies at the maturity of the contract or upon its surrender shall not be included as income (Clause B); for though they come in, they constitute neither gains nor profits.

Often receipts come in which are but a change of capital investment, or which represent a distribution of capital assets. In that case there is no gain or profit. If such receipts are regarded as income, the taxpayer's capital is depleted. Suppose on November 1, 1912, a resident of New York bought a hundred shares of Fifth Avenue Bank stock and paid therefor \$410,000, the market value of these shares, viz., \$4,100 per share of \$100 par value. The next March the bank decides to distribute its entire surplus, all earned prior to the year 1913; and declares an extraordinary cash dividend of \$4,000 per share. The purchaser of the one hundred shares would receive \$400,000 in cash and would still retain his one hundred shares, which would be worth \$100 per share, instead of \$4,100. He immediately sells the one hundred shares and receives therefor \$10,000. His total receipts from the dividend and sale of his shares are \$410,000, the amount with which he started a few months before. Yet, according to the Treasury Department's construction of the Act, he must treat \$400,000 as a profit and pay a large tax thereon. There has, however, been no gain or profit. Such a dividend would be analogous to a dissolution dividend and constitute a

distribution of capital. The unfortunate investor could not deduct from his income, as a loss, the difference between the purchase price of the stock and what he sold it for; because under the terms of the Act this would not be a loss sustained in trade (T. D., 2135).

Where the surplus distributed by the bank accrued in prior years, it has for the purposes of the Act become capital, and when declared as a dividend is a distribution of capital. It is not a distribution of gains or profits "accruing or arising" in the year 1913. The rulings of the Treasury Department recognize this distinction by holding that a dissolution dividend of the entire capital and surplus of a corporation does not constitute taxable income. Yet what valid distinction can be made between a distribution of surplus by a going concern and a distribution of surplus on a dissolution of the corporation?

It may be that in some cases a minority stockholder cannot compel the payment of a dividend. He can, however, always obtain the benefit of an earned surplus by the sale of the stock.

In *Collector v. Hubbard*, 12 Wall, 1, 17, the court held that stockholders were the owners of the undistributed profits of their corporation and were taxable thereon under the Federal income tax law of 1864. A portion of the opinion is as follows:

"Decided cases are referred to, in which it is held that a stockholder has no title for

certain purposes to the earnings, net or otherwise, of a railroad prior to the dividend being declared, and it cannot be doubted that those decisions are correct as applied to the respective subject-matters involved in the controversies. Grant all that, still it is true that the owner of a share of stock in a corporation holds the share with all its incidents, and that among those incidents is the right to receive all future dividends, that is, his proportional share of all profits not then divided. Profits are incident to the share to which the owner at once becomes entitled provided he remains a member of the corporation until a dividend is made. Regarded as an incident to the shares, undivided profits are property of the shareholder, and as such are the proper subject of sale, gift, or devise. Undivided profits invested in real estate, machinery, or raw material for the purpose of being manufactured are investments in which the stockholders are interested, and when such profits are actually appropriated to the payment of the debts of the corporation they serve to increase the market value of the shares, whether held by the original subscribers or by assignees."

Bailey v. R. Co., 106 U. S., 109.

Under a number of the earlier income tax laws an undistributed corporate surplus has actually been taxed as a part of the stockholders' income.

13 Stat. L., 281, Sec. 117;

16 Stat. L., 257, Sec. 7.

If an undistributed surplus of a corporation is a part of the stockholders' income, it must become income at the time it accrues and not when it is distributed.

To construe the Act, therefore, as imposing a tax on dividends from a surplus accruing prior to March 1, 1913, would result in giving the Act a retroactive effect and would violate a cardinal rule of statutory construction.

Reynolds v. M'Arthur, 2 Pet., 417, 434;
U. S. v. Burr, 159 U. S., 78;
U. S. v. American Sugar Refining Co.,
 202 U. S., 563;
Lynch v. Turrish, 236 Fed., 653 (C. C.
 A.).

In *Reynolds v. M'Arthur*, *supra*, Chief Justice Marshall referred to a retrospective construction of a statute as "odious", and said:

"It is a principle which has always been held sacred in the United States, that laws by which human action is to be regulated look forwards, and not backwards; and are never to be construed retrospectively, unless the language of the act shall render such construction indispensable."

What the Act means by the words "gains, profits and income," therefore, is not receipts derived from a conversion of capital, such as the distribution of a pre-existing surplus, but a net accretion to capital during the tax year, the capital itself remaining intact.

(b) *It is not enough that gains or profits were received within the year, but they must have been gains or profits "arising or accruing during" such year.*

The taxpayer's taxable receipts are his "entire net income arising or accruing during" the year [Clause G, subd. (a); see also Clause A, subd. 1].

This language is not indicative of an intention to tax receipts merely because received in a given year, but is strongly suggestive of an intention to look further and ascertain at what time the gain or profit became an accretion to capital. In the two most important clauses of the statute, the one imposing a tax on individuals and the other imposing a tax on corporations, the language is the same. It is not the net income *received within* the year, nor even the net income that *accrued or arose within the year*, but it is the net income "*arising or accruing during*" or "*in*" the year. The language is that of a continuing, not a completed transaction. The statute looks to the period "*during*" which the accretion to capital is gradually taking place, not the moment at which it is actually reduced to possession.

It is true that in some portions of the Act different phraseology is used that might indicate an intention to tax all receipts, but in the two important clauses imposing the tax, the language is chosen with nicety. These are the two paramount clauses and define the tax. Other clauses of the Act should be construed with reference to them.

The meaning of the word "accrue" was considered in *Anderson v. Richards' Executors*, 99 Ky., 661. It was there held that rent should be apportioned between the lessor's executors and the devisee of the land as of the date of the lessor's death, the court saying:

"The contention of appellant [the devisee] seems to be that, inasmuch as the rent was not due or the term ended at the date of the death of the testator that the whole of such rent must be deemed to have accrued after the death of the testator. We find that Mr. Webster defines accrue: 'First, to increase; to augment. Secondly, to come to by way of increase; to arise or spring as a growth or result; to be added as increase, profit or damage, especially as the produce of money lent; interest accrued to principal.' "

Bouvier's Law Dictionary, Rawle's Rev., gives the following definition: "Accrue: To grow to; to be added to, as the interest accrues on the principal * * *."

The Concise Oxford Dictionary defines the word as to "Fall to one from a thing as a natural growth, advantage, result; especially of interest on invested money."

Strasser v. Staats, 59 Hun, 143, held that a by-law of a mutual benefit association, providing that the dues of members shall "accrue weekly" meant that the dues were to be established or measured weekly, and did not mean payable weekly.

Black defines the word "accruing" as meaning "inchoate; in process of maturing; that which may or will at a future time ripen into a vested right, an available demand, or an existing cause of action."

Ercanbrack v. Faris, 10 Idaho, 584;
In re Mifflin's Estate, 232 Pa. St., 25;
Carley v. Mfg. Co., 81 N. J. L., 502, 508;
Leman v. Chipman, 82 Nebr., 392, 396.

All the authorities give "arise" as one of the synonyms of "accrue."

Although interest is not payable until a subsequent date, it is regarded as accruing from day to day. It is apportionable between life tenant and remainderman.

2 Perry on Trusts (6th Edition), 556, says:

"Interest-money upon notes, bonds, mortgages, and similar securities *accrues* from day to day, although it is not payable until a fixed day; it is therefore apportionable and trustees must pay the proportion accruing during the life of the tenant for life to his representative."

See to same effect *Bridgeport Trust Co. v. Marsh*, 87 Conn., 384, 398, and cases there cited.

The Treasury Department supports this construction by holding that one who purchases a bond between two interest dates is not liable for an income tax on so much of the interest as had accrued at the time of purchase, notwith-

standing the interest was not then payable, but became due later. (See Commissioner of Internal Revenue's letter of February 5, 1915, to Corporation Trust Company and of March 8, 1915, to Matz, Fisher & Boyden.)

So, also the Treasury Department rules that an interest coupon which was payable prior to March 1, 1913, does not constitute taxable income, even though collected by the couponholder after that date. In such case the interest, though it comes in after March 1, 1913, is not a gain or profit "accruing or arising during" that period.

The use, in imposing the tax, of a phrase that is universally applied to the gradual accretion of interest to principal—an accretion which it is well settled is apportionable—is another indication of the intent of Congress not to tax a gain when received, but when earned.

(c) It is significant that the Act makes a distinction between dividends and the income derived from dividends.

A dissolution dividend distributing the corporate capital, or a dividend declared from other than net earnings accruing since the adoption of the Sixteenth Amendment to the Federal Constitution, would not constitute taxable gains or profits, and in no case would it be necessary to include them in the taxpayer's annual return. Hence, in prescribing what an individual shall set forth in his annual return, the Act adds a proviso

that persons liable to the normal tax only "shall not be required to make return of the *income derived from dividends* on the capital stock or from the *net earnings* of corporations, joint stock companies or associations, and insurance companies taxable upon their net income" as provided in the Act (Clause D).

Similarly, the Act defines "net income" as including not all corporate dividends, but "gains, profits and income derived from * * * dividends" (Clause B).

As already stated, the Treasury Decisions with regard to dissolution dividends recognize the fact that all corporate dividends do not constitute taxable income.

That as between life tenants and remaindermen dissolution dividends constitute capital has repeatedly been held.

Gifford v. Thompson, 115 Mass., 478;
Brownell v. Anthony, 189 Mass., 442;
Church v. Colegrove, 74 Conn., 79;
Curtis v. Osborn, 79 Conn., 555, 562;
Wheeler v. Perry, 18 N. H., 307;
Wilberding v. Miller (Ohio), 106 N. E.,
 665.

(d) *The Act recognizes that a stockholder is the owner of his pro rata share of the corporate surplus before it is distributed in the shape of dividends.*

Though the surplus may be distributed in a later year as a dividend, the benefit of the surplus

accrues to the stockholder as soon as the surplus is earned. This benefit may be reaped by the stockholder through a sale of his stock at an advanced price, the advance being the result of the accumulated surplus; or in a proper case he may even go into a court of equity and compel the payment of a dividend. The Act recognizes that stockholders own the undistributed surplus of their corporation and taxes them thereon in certain cases. The Act provides:

“For the purpose of this additional tax the taxable income of any individual shall embrace the share to which he would be entitled of the gains and profits, if divided or distributed, whether divided or distributed or not, of all corporations, joint-stock companies, or associations however created or organized, formed or fraudulently availed of for the purpose of preventing the imposition of such tax through the medium of permitting such gains and profits to accumulate instead of being divided or distributed.”

Clause A, subd. 2.

Similarly, the Federal income tax law of 1870 provided:

“That in estimating the gains, profits, and income of any person, there shall be included * * * the share of any person of the gains and profits, whether divided or not, of all companies or partnerships * * *.”

16 Stat. L., 257, Sec. 7.

Substantially the same provision is contained in the Federal income tax law of 1864.

13 Stat. L., 281, Sec. 117.

Such taxation is valid.

Collector v. Hubbard, 12 Wall., 1, 17;

Bailey v. R. Co., 106 U. S., 109.

If a corporate surplus, before it is declared as a dividend, is income of a stockholder in such sense as to be subject to the income tax, it follows that the surplus must have become income of the stockholder as soon as it was earned by the corporation; and if it was earned by the corporation prior to the adoption of the Sixteenth Amendment, such surplus cannot be regarded as income which can be taxed, but must be regarded as capital.

(e) *The Act requires an individual to pay an "additional tax" on dividends where his income exceeds a prescribed amount, thus implying that the tax is supplemental to another and prior tax. But the individual pays no normal tax on dividends, and the corporation pays no income tax on surplus earned prior to March 1, 1913. Hence, in the case of dividends from such surplus, to what would the "additional tax" be an addition?*

While an individual subject only to the "normal tax" does not include in his return "income derived from dividends," nor pay a tax thereon, the case is otherwise where the individual is sub-

ject to the "additional tax." The term "additional tax" implies that the tax is a supplement to, or increase of, another and prior tax. It would be a contradiction in terms to say that any given income is subject to the additional tax, unless it is also subject to the normal tax. The evident intent of the statute is to avoid double taxation, except in the case of dividends paid to holding companies. The corporation paying the dividend is not subject to the additional tax; hence income derived from the dividend is subjected thereto, in case the recipient is an individual with a net income in excess of \$20,000 for the taxable year. On the other hand, dividends received by individuals subject only to the normal tax are not taxable if received from corporations "taxable upon their net income," the theory being that the corporations have in such case paid the tax. But manifestly no income tax could be levied or imposed upon a corporation in respect of surplus earned by it prior to the adoption of the Sixteenth Amendment; nor has the Act attempted to levy or impose any such tax on corporations. As neither the corporation owning the surplus nor an individual receiving a dividend thereof can be required to pay the normal tax thereon, if it is sought to impose the "additional tax" on the dividend received by the individual, to what is the additional tax? an addition? No normal tax is possible; therefore there can be no additional tax. This is but further inherent evidence of the fact

that the statute did not attempt to impose a tax, additional or otherwise, on a corporate surplus earned prior to March 1, 1913.

(3) THE ACT SHOULD BE SO CONSTRUED AS TO AVOID RAISING ANY QUESTION AS TO ITS CONSTITUTIONALITY.

If the Act is given the construction for which the Government contends, it is unconstitutional. This question is discussed not only in the brief of the plaintiff in error but also in the brief submitted December 10, 1917, in opposition to the motion to dismiss for lack of jurisdiction in the case of *Southern Pacific Company v. Lowe*, No. 452, on the present docket of this court. But even if the invalidity of the Act, if so construed, were less plain, the constitutional question should be avoided by holding the dividends in question not subject to the tax. Only "income derived from dividends" should be taxed, not dividends of pre-existing surplus which do not constitute income.

In *Harriman v. I. C. C.*, 211 U. S., 407, 422, the court held that the Interstate Commerce Act did not authorize the compulsory exaction of the testimony there sought, saying (Holmes, J.):

"If we felt more hesitation than we do, we still should feel bound to construe the statute not merely so as to sustain its constitutionality but so as to avoid a succession of constitutional doubts, so far as candor permits.

Knights Templar & Indemnity Co. v. Jarman,
187 U. S., 197, 205."

In *United States v. Jin Fuey Moy*, 241 U. S.,
394, 401, the court said (Holmes, J.):

"A statute must be construed, if fairly possible, so as to avoid not only the conclusion that it is unconstitutional but also grave doubts upon that score. *United States v. Delaware & Hudson Co.*, 213 U. S., 366, 408."

(4) STATUTES IN PARI MATERIA AND DECISIONS THEREUNDER.

Statutes *in pari materia* are to be read and construed together as the development of a uniform and consistent legislative design, or else as the modification of the original design to adapt it to changing conditions.

"And it is said that the rule of construction by the aid of statutes *in pari materia* is especially applicable in the case of revenue laws, which, though made up of independent enactments, are regarded as one system, in which the construction of any separate act may be aided by an examination of other provisions which compose the system."

Black on Income Taxes (2nd Edition),
Sec. 218;

Citing *United States v. Collier*, 3 Blatchf.,
325; Fed. Cas. No. 14,833.

And the rule is still applicable notwithstanding the earlier statute has been repealed.

King v. Loxdale, 1 Burr., 445;
Southern Railway Company v. McNeill,
 155 Fed., 756.

In *United States v. Smith*, 1 Sawy., 277; Fed. Cas. No. 16,341, it was held that all the successive acts of Congress from 1861 to 1867, imposing income taxes, were *in pari materia* and were to be construed as one continuous enactment, "and," says Black in his work on Income Taxes, Sec. 218, "of course, this doctrine may be expanded so as to include the acts of Congress of 1894, 1909 and 1913."

It becomes important, therefore, to ascertain what construction has been placed upon the provisions of the earlier Federal income tax laws as respects dividends. In this connection it will be noticed that the income by which the Federal excise tax of 1909 is measured includes dividends "received" during the year, while all the various Federal income tax laws refer to "income derived from" dividends; except the laws of 1916 and 1917, which specifically define the dividends that are taxable. There is good reason for this change of phraseology; for an excise tax might be measured by a standard upon which an income tax could not be constitutionally imposed.

Stratton's Independence v. Howbert, 231
 U. S., 399;

Flint v. Stone Tracy Co., 220 U. S., 107,
162;

Pollock v. Trust Co., 157 U. S., 429, 586.

The intent of Congress not to attempt to impose an income tax on dividends paid out of surplus accrued prior to the adoption of the Sixteenth Amendment is shown by the language of the Federal income tax act approved September 8, 1916. That act imposes a tax on "net income received" instead of on net income arising or accruing, and Congress, therefore, deemed it necessary to add to the definition of net income a proviso explicitly stating that the term "dividends" as there used

"shall be held to mean any distribution made or ordered to be made by a corporation * * * out of its earnings or profits *accrued since March first, 1913* * * *."

39 Stat. L., 757, Sec. 2 (a), and 766, Sec. 10.

A similar but more elaborate provision is contained in the War Revenue Law of 1917. In the new law, after the phrase quoted above, is added the following:

"But nothing herein shall be construed as taxing any earnings or profits accrued prior to March 1, 1913, but such earnings or profits may be distributed in stock dividends or otherwise, exempt from the tax, after the

distribution of earnings and profits accrued since March 1, 1913, has been made."

(Sec. 31 added to Income Tax Act of Sept. 8, 1916, by Sec. 1211 of War Revenue Law of 1917.)

The defendant's argument *ab inconvenienti*, that Congress could not by the Act of 1913 have intended to put the Treasury Department officials to the inconvenience of ascertaining the sources from which dividends were paid, falls flat in the face of the provisions of the Acts of 1916 and 1917, provisions so specific that they cannot be construed away by Treasury decisions. Moreover, the inconvenience to the Treasury Department is more fancied than real, as the burden is on the taxpayer to prove that the dividend is not taxable.

Bailey v. R. Co., 106 U. S., 109, 116.

Indeed, the *Bailey* case is a complete answer to all of the defendant's contentions. It arose under the Federal income tax law of 1864 and came before this court twice (22 Wall., 604, and 106 U. S., 109). In that case, during a period of fifteen years, from 1853 to 1868, the New York Central Railroad Company had expended from its earnings large amounts for additions and betterments and the acquisition of property. In the latter year it declared a scrip dividend of eighty

per cent. on its capital stock, upon which an internal revenue tax of five per cent. was assessed, with an added penalty of \$1,000, under Sec. 122 of the Act of 1864, providing as follows:

“That any railroad, * * * company * * * that may have declared any dividend in scrip, or money due or payable to its stockholders, as part of the earnings, profits, income, or gains of such company, and all profits of such company carried to the account of any fund, or used for construction, shall be subject to and pay a duty of five per centum on the amount” thereof “*whenever the same shall be payable.*”

43 Stat. L., 284.

From this assessment, amounting to over \$1,000,000, the Company appealed. As the scrip dividend representing earnings accrued during a period of fifteen years, of which only six years were covered by the income tax law, which first took effect in September, 1862, the Secretary of the Treasury remitted the tax on nine-fifteenth of the dividend and assessed the tax on the remainder, together with penalty and interest. Suit was brought against the collector to recover the tax so exacted. On the first trial the lower court took the view that the transaction did not constitute a scrip dividend within the meaning of the statute, and, therefore, the assessment was

held void. This judgment was reversed (22 Wall., 604). The second trial resulted in a verdict for the Railroad Company, which on appeal, was affirmed by this court.

The case cannot be distinguished upon the ground that the Act of 1864 was imposed on the corporation paying the dividend, while under the Act of 1913, the tax is upon the income of the recipient. The court expressly made its decision independent of this question, saying upon the second appeal (p. 116):

“There has been a difference of opinion upon the point whether the tax imposed by this section is upon the corporation, on account of its net profits, or upon the income of the stockholder or bondholder; although in the present case it is immaterial which of these alternatives is adopted.”

The language of the Act of 1864 was more favorable to the Government's contention than is the language of the Act of 1913. The former imposed the tax on any dividend payable “as part of the earnings, profits, income or gains of such company * * * *whenever the same shall be payable*”; the latter, upon the entire net income (namely, “gains, profits and income,” less deductions and exemptions) “arising or accruing from all sources during the preceding calendar year.” In one case the tax is upon the income when *payable*; in the other, when *arising or accruing*.

Nevertheless, this court approved the charge of the trial judge, the substance of which (p. 111):

“upon the main point was, that while the certificates constituted a scrip dividend, which justified the assessment and constituted a complete *prima facie* defence to the action, nevertheless it was competent for the plaintiff to show what amount of the earnings of the Company, accruing from September 1, 1862 [the effective date of the act], to December 19, 1868, was represented by, and included in, the certificates; and that this amount alone being subject to the tax, the plaintiff was entitled to recover all which in excess thereof had been exacted and paid.”

The court recognized that a dividend *prima facie* constituted taxable income, but that this presumption might be rebutted by proper proof, saying (p. 116):

“It was quite legitimate for the assessor to treat this [scrip dividend] as evidence of an amount of earnings which had never been taxed, and make the assessment accordingly. It was equally legitimate for the Secretary of the Treasury, upon proof that the accumulation had been going on from the organization of the company, in 1853, to apportion the amount in equal proportions for each year, and to deduct nine-fifteenths thereof for the years which had elapsed before the taking effect of the act taxing incomes. And it is entirely consistent with the declaration itself to show in point of fact what was the amount

of earnings accrued during the period while the income-tax act was in force which had not been assessed for taxation as profits carried to construction or other account. The declaration in the certificates could not be conclusive of anything not inconsistent with it, for an estoppel only prohibits contrary allegations. The proof admitted on the trial below did not contradict the certificates, but only served to rebut a presumption, which, as matter of law, was not conclusive. Its tendency and effect were to exact from the company the full tax upon every dollar of its earnings, which had not previously paid its proper assessment, and which, in any form, was subject to taxation, and to relieve it only to the extent to which otherwise it would have been subjected to the payment of a second tax upon the same fund. This result, and the process by which it was reached, seem to us strictly to conform both to the letter and spirit of the law governing the subject."

There the dividend had been declared and paid after, but earned before, the Act of 1864 became effective, and the contention of the Treasury Department was substantially the same as here. This contention, which was held to be unsound, was stated by the court to be as follows (p. 114):

"It is now urged in argument that, upon the express terms of this section, the certificates in question being a declaration of a dividend as part of the earnings, profits, income, or gains of the company, are taxable upon the amount thereof, without deduction; that the

policy as well as the language of the act fixes the charge upon the declaration itself when made effectual between the company and its stockholders, and, for the purpose of taxation, concludes both as to the amount subject to the tax; and that the rule is reasonable as furnishing an obvious standard and the only safe criterion for the assessment of the tax to prevent fraudulent evasions. And consequently that when such a dividend has once been declared, and ascertained to come within the description of the law as a subject of taxation, all the rest follows, and the amount declared is necessarily established as the amount to be taxed."

The court declined to adopt this standard because it was "the only safe criterion for the assessment of the tax to prevent fraudulent evasions," but was governed by the letter and spirit of the statute, stating that the tax was "an annual income tax," and that "its subject is the interest paid and profits earned by the Company for each year, and year by year," just as the Act of 1913 is an annual tax on net income arising or accruing "during the preceding calendar year."

In *Reynolds v. Williams*, 4 Biss., 108; Fed. Cas., No. 11,734, a railroad company had invested in Government bonds the sum of \$100,000 earned prior to July 2, 1863. In 1867 the railroad company consolidated with another company and placed these bonds in the hands of the plaintiff, as trustee for its stockholders, the company first

mentioned ceasing to exist. In 1868 a five per cent. tax was assessed upon the bonds under the income tax law then in force, upon the ground that the bonds accrued to the stockholders as income at the time they were placed in the hands of the trustee. The statute under which the tax was imposed provided:

"That there shall be levied, collected, and paid annually upon the annual gains, profits, and income of every person * * * whether derived from any kind of property, rents, interests, dividends, salaries, or from any profession, trade, employment, or vocation, * * * or from any other source whatever," a tax, &c. (13 Stat. L., 479).

The court held the tax improperly assessed, and answered in the negative the following question, which it said seemed to be the only question involved:

"Was said sum of \$100,000 of United States bonds either gains, profits or income acquired within the year 1867 in the sense in which these terms are used in the Act above cited?"

A further portion of the opinion is as follows:

"A railroad corporation is a mere ideal thing; and yet, in legal consideration, it is the owner of all the property which it controls—the road, the rolling stock, the capital stock, the accumulated funds. But, in my opinion, it being a merely artificial person, is

only the legal owner of the property in trust for all the natural persons who are interested in it, including all stockholders, and all creditors.

“Now, it appears by the declaration that the bonds in question had been acquired by the railroad company as early as 1863. This accumulated fund remained on hand till the company ceased to be. For whose use did the company hold this fund? Not for the use of its creditors; for it does not appear to have owed any debts. So far as appears, the stockholders were the only natural persons in the world who had any interest in this fund; and it evidently follows that this artificial person, the railroad company, held it in trust for its stockholders. Hence, it is clear that, though the corporation was the legal owner of the bonds, yet the stockholders were the equitable owners of them; or—to say the least—had an equitable interest in them. I must conclude, therefore, that the beneficiaries for whom the plaintiff held these bonds in 1867 had some interest in them before that year; and that consequently the bonds were not wholly an acquisition of ‘gains, profits and income’ accruing to them in that year.”

There again the Government’s contention was substantially the same as here. A tax was sought to be imposed on the bonds because the dividend of them had been declared in 1867, and they had then been placed in the hands of a trustee for the stockholders; but the court in construing the income tax law looked behind the legal fiction of

distinct corporate entity, and recognized that the stockholders were the equitable owners of the corporate earnings and that these earnings had accrued to them before the enactment of the statute.

In *Merchants Insurance Company v. McCartney*, 1 Lowell, 447; Fed. Cas., No. 9,443, the same statutory provision was involved as in the preceding case. The plaintiff Insurance Company, as one of the stockholders in the Suffolk Bank, had paid under protest an income tax assessed under the Act of 1864 upon the whole of an extra dividend declared by the Bank. Three-tenths of this dividend consisted of profits earned and laid aside by the Bank before the enactment of the income tax act there in question. The court held that the plaintiff was entitled to recover the tax paid on this three-tenths, and said (Lowell, *D.J.*):

“As to the three-tenths, it seems to me to have been a division of capital, a return to the plaintiffs in money of a part of the property which was already in their ownership as capital stock when the first Act was passed. If the Suffolk Bank had been wholly wound up, and had returned to its stockholders the exact value of their shares in money, having made no profits since the passage of the original Act, this sum of money could not be taxed as income, gains or profits; and so of a part. If the plaintiffs on receiving the money, chose to divide it among their own stockholders, still it is not a dividend out of gains and profits, nor out of the surplus funds, because the surplus funds that are taxable are those

which are or have been made out of profits since the passage of the Act. This view appears to have been acquiesced in by the Government, for they have neglected for some five years to enforce the opposite construction against the Bank; and if this money was capital in the hands of the Bank it was still capital when it reached the stockholders. The tax is assessed on the Bank for convenience, but is intended to be, in effect, a tax on the shareholders; and if the latter be not assessable for the income tax, it cannot be levied on the corporation. *Railroad Company v. Jackson*, 7 Wall. (74 U. S.), 262."

In a later portion of the same opinion the learned judge stated that in drawing the foregoing conclusion he had not referred to the language of the statute, "because it seemed to me the result was the same *upon any fair meaning of the word income.*"

Gray v. Darlington, 15 Wall., 63, was an action to recover an income tax paid under protest. In 1865 the plaintiff had acquired certain Government bonds, which he sold in 1869 at an advance of \$20,000, and on this sum the tax was assessed under the Act of March 2, 1867, which provided that:

"There shall be levied, collected, and paid *annually* upon the gains, profits, and income of every person, * * * whether derived from any kind of property, rents, interest, dividends, or salaries, or from any profession, trade, employment, or vocation, * * * or from

any other source whatever, a tax of five per centum * * *. And the tax herein provided for shall be assessed, collected, and paid upon the gains, profits, and income for the year ending the thirty-first day of December next preceding the time for levying, collecting, and paying said tax."

14 Stat. L., 478.

The statute manifested an intention to tax profits derived from the sale of property, for it contained a further provision that

"profits realized within the year from sales of *real estate* purchased within the year, or within two years previous to the year for which income is estimated,"

should be included in the taxable income, and also

"*all other gains, profits, and income derived from any source whatever.*"

The Act of 1867 contained no restriction as to the time within which personal property must have been acquired in order that profits realized from its sale should be included as taxable income; and it will be noticed that the statute twice defined taxable income as gains, profits, and income "*derived from any source whatever.*" Nevertheless, this court held that profits from the sale of the bonds in question were not taxable and that the plaintiff was, therefore, entitled to recover. Stress was laid upon the fact that the tax was imposed upon the *annual* gains of a person

and included only such income as might "be realized from a business transaction begun and completed during the preceding year," with an exception as to profits from sale of real property within the two previous years. A portion of the opinion is as follows (p. 66):

"The mere fact that property has advanced in value between the date of its acquisition and sale does not authorize the imposition of the tax on the amount of the advance. Mere advance in value in no sense constitutes the gains, profits, or income specified by the statute. It constitutes and can be treated merely as increase of capital.

"The rule adopted by the officers of the revenue in the present case would justify them in treating as gains for one year the increase in the value of property extending through any number of years, through even the entire century. The actual advance in value of property over its cost may, in fact, reach its height years before its sale; the value of the property may, in truth, be less at the time of the sale than at any previous period in ten years, yet, if the amount received exceed the actual cost of the property, the excess is to be treated, according to their views, as gains of the owner for the year in which the sale takes place. We are satisfied that no such result was intended by the statute."

Under the Corporate Excise Tax Act of 1909, where a lumber company had purchased

timber lands years before, and the Government sought to include the increased value of the timber in the profits resulting from a sale of the manufactured lumber, the Circuit Court of Appeals said:

"It is clear that, by the term 'income' Congress did not intend to include the proceeds of capital assets sold or converted during the year; nor can it be material whether such proceeds are reinvested in other property or remain in the treasury of the company or are distributed to the stockholders; nor whether, in case of such distribution, they are called dividends or capital. The controlling question must be whether assets so converted were in fact, at the beginning of the tax period, property to be classed as assets. If they were of that character, they cannot be income received during the latter period; they represent merely capital in a changed form."

Mitchell v. Doyle, 225 Fed., 437.

The decisions under the Act are fully discussed in the brief of the plaintiff in error.

(5) AS BETWEEN LIFE TENANT AND REMAINDERMAN, NOT ONLY A STOCK DIVIDEND CONSTITUTES CAPITAL, BUT SO ALSO DOES A CASH DIVIDEND, IF PAID FROM SURPLUS ACCRUING PRIOR TO THE ESTABLISHMENT OF THE TRUST.

There is a wealth of authority on this subject and it is the well settled rule of a majority of the

States of the Union—a majority which in recent years seems to be increasing—that an extraordinary dividend of cash is to be apportioned between life tenant and remainderman in respect to the time of the accrual of the surplus out of which the dividend was paid. The same rule has often been applied to stock dividends.

Mr. Cook in his great work on Corporations refers to the foregoing statement of the law as constituting the “American Rule.” He says (Vol. 2, 7th Edition, Sec. 554):

“This rule, inasmuch as it obtains in nearly every state in the Union, may well be called the American rule. It proceeds upon the theory that the Court, in disposing of stock or property dividends, as between life tenant and remainderman, may properly inquire as to the time when the fund out of which the extraordinary dividend is to be paid was earned or accumulated, and also as to the method of accumulation. If it is found to have accrued or been earned before the life estate arose, it may be held to be principal, and, without reference to the time when it is declared or made payable, to belong to the *corpus* of the estate, and not to go to the life tenant. But when it is found that the fund, out of which the dividend is paid, accrued or was earned, not before but after the life estate arose, then it may be held that the dividend is income, and belongs to the tenant for life.”

The same author expresses his opinion that where the extraordinary dividend represents

"profits which were earned or accumulated before the life tenancy began * * * it is clear that in justice the remainderman should receive it. If, however, it was earned after the life tenancy began, it is clear that the life tenant should have it. If it was earned partly before and partly after the life tenancy began, then it is apparent that in justice some apportionment should be made if possible" (*id.*, Sec. 552).

See to same effect:

Morawetz on Corporations (2nd Edition), Sec. 467;

Thompson on Corporations (2nd Edition), Vol. 2, Sec. 5414.

The latter author thus states the rule:

"The courts now inquire into the actual nature and source of dividends for the purpose of determining their character. * * * The court in making the inquiry concerns itself with the substance of the transaction, and not the form in which the corporation has seen fit to clothe it."

The principle stated by the text writers is sustained by the following authorities, among many others:

In re Stokes, 240 Pa. St., 277 (1913);

Earp's Appeal, 28 Pa. St., 368;

Matter of Osborne, 209 N. Y., 450 (1913);

Matter of Harteau, 204 N. Y., 292;

Thayer v. Burr, 201 N. Y., 155;

Ballantine v. Young, 79 N. J. Eq., 70, 73;
Lang v. Lang's Executor, 57 N. J. Eq.,
 325;

Van Doren v. Alden, 19 N. J. Eq., 176;

Bishop v. Bishop, 81 Conn., 509;

Church v. Colegrove, 74 Conn., 79;

Holbrook v. Holbrook, 74 N. H., 201;

Peirce v. Burroughs, 58 N. H., 302;

Lord v. Brooks, 52 N. H., 72;

Miller v. Payne, 150 Wis., 354 (1912);

Soehnlein v. Soehnlein, 146 Wis., 330,
 340;

Gilkey v. Paine, 80 Me., 319;

Ex Parte Rutledge, 1 Harp., 65;

Cobb v. Fant, 36 S. C., 1;

Goodwin v. McGaughey, 108 Minn., 248,
 256;

See Authorities cited *ante*, p. 6.

In *Matter of Osborne*, 209 N. Y., 450, 474, decided in December, 1913, the court said:

"It is conceded that the capital of a corporation cannot be divided among the life beneficiaries. It is not alone the *capital of the corporation* that should be preserved, but the *capital of the trust fund* whether invested by the trustees in stocks of corporations at a premium, or acquired from the testator or maker of the trust. The surplus of the corporation existing at the formation of the trust or when the stock is purchased represents a part of the capital of the estate as fully as does the capital of the corporation. The division by corporations of their surplus accumulated through a long period of years in

very large amounts is now comparatively common, when until within a very recent time such division of enormous amounts was seldom, if ever, made."

The court said that "the rights of the contending parties" should be determined "according to justice and equity," notwithstanding that in some cases the necessity for apportionment might cause difficulty, and continued (p. 477) :

"In case of extraordinary and unusual dividends declared in whole or in part from earnings actually accumulated prior to the creation of the trust or the purchase of the stock an adherence to the rule that dividends are deemed to have been earned as of the date of their declaration in many cases shocks the sense of justice."

On motion to amend the remittitur, in the same case, the court prescribed a simple method of making the necessary apportionment as follows (pp. 484-5) :

"The proposition decided by us in this case is, that in all cases of extraordinary dividends, either of money or stock, sufficient of the dividend must be retained in the corpus of the trust to maintain that corpus unimpaired and the remainder thereof must be awarded to the life beneficiary. The method of accomplishing this result is not difficult. The intrinsic value of the trust investment is to be ascertained by dividing the capital and the surplus of the corporation existing at the

time of the creation of the trust by the number of shares of the corporation then outstanding, which gives the value of each share, and that amount must be multiplied by the number of shares held in the trust. The value of the investment represented by the original shares after the dividend has been made is ascertained by exactly the same method. The difference between the two shows the impairment of the corpus of the trust. If the dividend is of money the amount of that difference is to be retained by the trustee as capital, and the remainder paid to the life beneficiary. If the dividend is in stock the amount of impairment in money must be divided by the intrinsic value of a share of the new stock, and the quotient gives the number of shares to be retained to make the impairment good—the remaining shares going to the life beneficiary. Market value, good will and like considerations cannot be considered in apportioning a dividend.”

In *Lang v. Lang's Executor*, 57 N. J. Eq., 325, 329, the court said:

“We think that when a dividend is declared out of earnings, the reasonable presumption is that these earnings have been made uniformly, day by day, since the last similar dividend was declared, leaving the parties in interest at liberty to show that the earnings were really made differently.”

Mr. Cook says (Vol. 2, 7th Edition, Sec. 555) that Massachusetts, Georgia, Rhode Island and

Illinois have adopted another rule—a rule of convenience. In those States cash dividends are generally regarded as income and go to the life tenant, while stock dividends are regarded as capital and go to the remainderman. This is frequently referred to as the “Massachusetts Rule” or “Rule in Minot’s Case.” It was announced in the case of *Minot v. Paine*, 99 Mass., 101 (1868) as follows:

“A simple rule is to regard cash dividends, however large, as income, and stock dividends, however made, as capital.”

Mr. Cook comments that while a simple rule, it “works great hardship and injustice in many cases” and “is not rigidly adhered to.”

Judge Thompson’s adverse criticism of the rule appears in Sec. 5410 of the second volume of the second edition of his work on Corporations.

“The Massachusetts doctrine seems to be a rule of mere convenience, and not of justice. It loses sight of the real question under consideration, what is *capital of the estate* disposed of by the will and not what is capital of the corporation.”

26 Am. L. Rev., 18.

As an evidence that the Massachusetts Court cannot consistently follow the rule laid down by it, see the following cases:

Johnson v. Mfg. Co., 80 Mass., 274;
Heard v. Eldredge, 109 Mass., 258.

See also:

Leland v. Hayden, 102 Mass., 542, 550.

In *Heard v. Eldredge*, *supra*, a corporation declared a dividend of the proceeds of sale of property which had been taken by condemnation proceedings. Notwithstanding it was a cash dividend, the Court held it to be capital.

In *Johnson v. Mfg. Co.*, *supra*, a regular periodical cash dividend declared after a life tenant's death from surplus earned during the life tenancy was held to belong to the life tenant's estate and not to the remaindermen.

The court said:

"It is immaterial that the dividend sued for in this action was not declared until after her [the life tenant's] death; because it was for gain and profit earned and acquired during the year preceding the 31st day of May next before her death. It was income, therefore, which belonged to her, although preparation for its payment was not made until after her decease."

Moreover, in applying the rule of convenience to the disposition of dividends as between life tenant and remainderman, the courts are not hampered by the constitutional provisions which restrict the imposition of a Federal income tax. Except upon incomes, Congress has no power to levy direct taxes, unless apportioned among the several states according to population. Hence, if

a part of the regular periodical dividend is not income, but capital, no rule of convenience can justify the imposition of the tax. *Pollock v. Trust Co.*, 157 U. S., 429, 583-586. And where the amount of the dividend, whether regular or extraordinary, exceeds the entire surplus earnings accruing since March 1, 1913, it is manifest that such excess is not income, but capital, and a rule of convenience is not needed, as it is perfectly simple to ascertain what are surplus earnings during such period.

This court has not passed upon the question of the ownership of an extraordinary cash dividend as between life tenant and remainderman, although, as we have seen, it has held that it would look into the earnings from which the dividend was declared in determining whether the dividend was subject to the Income Tax Act of 1864 (*Bailey v. R. Co.*, *supra*). In *Gibbons v. Mahon*, 136 U. S., 549, 559, the court held that a *stock* dividend was capital and belonged to the remainderman. In the case of a stock dividend, however, there is no distribution of surplus, it is merely a declaration by the corporation of its intention to capitalize surplus. If the entire surplus amounting to one hundred per cent. is declared as a stock dividend, each stockholder simply has two shares worth \$100 each, in place of one share worth \$200. The stockholder's proportionate interest in the corporation is not changed. He has the same proportionate voting right, the same proportionate interest in

its property and earnings. These principles were stated in the court's opinion as follows:

"A stock dividend really takes nothing from the property of the corporation, and adds nothing to the interests of the shareholders. Its property is not diminished, and their interests are not increased. After such a dividend, as before, the corporation has the title in all the corporate property; the aggregate interests therein of all the shareholders are represented by the whole number of shares; and the proportional interest of each shareholder remains the same."

The decision turns largely upon the thought that the testatrix must have intended to leave to the corporate directors, the determination of the question whether or not a distribution of earnings should be made. The court said (p. 569):

"To hold the plaintiff to be entitled to the whole of the new shares issued to the defendant would be to allow the plaintiff the exclusive benefit of earnings, the greater part of which had accrued and had been invested by the company as capital before her interest began, and would be contrary to all the authorities. To award to her a proportion of those shares, based upon an account of how much of those earnings actually accrued after the death of the testatrix, would be to substitute the estimate of the court for the discretion of the corporation, lawfully exercised through its directors, and would be open to the practical inconveniences already stated."

It by no means follows that this court would decline to apportion an extraordinary *cash* dividend as between remainderman and life tenant according as the dividend was declared from surplus earned before or after the life tenancy began. As already stated, the court has pursued that course with regard to income taxes.

Bailey v. R. Co., 106 U. S., 109.

In accordance with this view, the lower Federal courts have held that they would go behind the mere declaration of an extraordinary cash dividend and ascertain from what earnings it was paid, in order to determine whether it belonged to the life tenant or remainderman.

Mercer v. Buchanan, 132 Fed., 501; 137 Fed., 1019 (C. C. A.).

Whatever view the courts may hold as to the intention of the maker of a trust to leave to the decision of corporate directors what shall be income and what capital, no such rule of convenience can be made applicable to the Federal income tax. But for the Sixteenth Amendment to the Constitution, this tax would be a direct tax and would be invalid unless apportioned among the several States according to their population (*Pollock v. Trust Co.*, 158 U. S., 601). Income accruing prior to the adoption of the constitutional amendment cannot, therefore, be subjected to the tax. Hence the question now under consideration

is a very different one from that ordinarily arising between life tenant and remainderman.

(6) A CONSTRUCTION OF THE ACT PRODUCING INEQUALITY AND HARDSHIP SHOULD BE AVOIDED.

In *Knowlton v. Moore*, 178 U. S., 41, 77, the present Chief Justice said with regard to the Federal Inheritance Tax Act of June 13, 1898 (30 Stat. L., 448):

"We are, therefore, bound to give heed to the rule, that where a particular construction of a statute will occasion great inconvenience or produce inequality and injustice, that view is to be avoided if another and more reasonable interpretation is present in the statute." (Citing cases.)

The Treasury officials' contention in this case is that a change in the form of capital without increase in the taxpayer's aggregate wealth constitutes taxable income. It results in taxing as income a mere conversion of capital. Even though the letter of the Act required such gross inequality and injustice as is contemplated by this contention—and we respectfully submit that it does not—the spirit of the Act as a tax on net income arising or accruing during the preceding year should control.

"Of course, if it were demonstrable that to read the [Corporate Excise Tax] Act according to its letter would render it unconstitutional, or glaringly unequal, or palpably unjust, a reasonable ground would exist for

construing it according to its spirit rather than its letter."

Stratton's Independence v. Howbert, 231
U. S., 399, 414.

Conclusion.

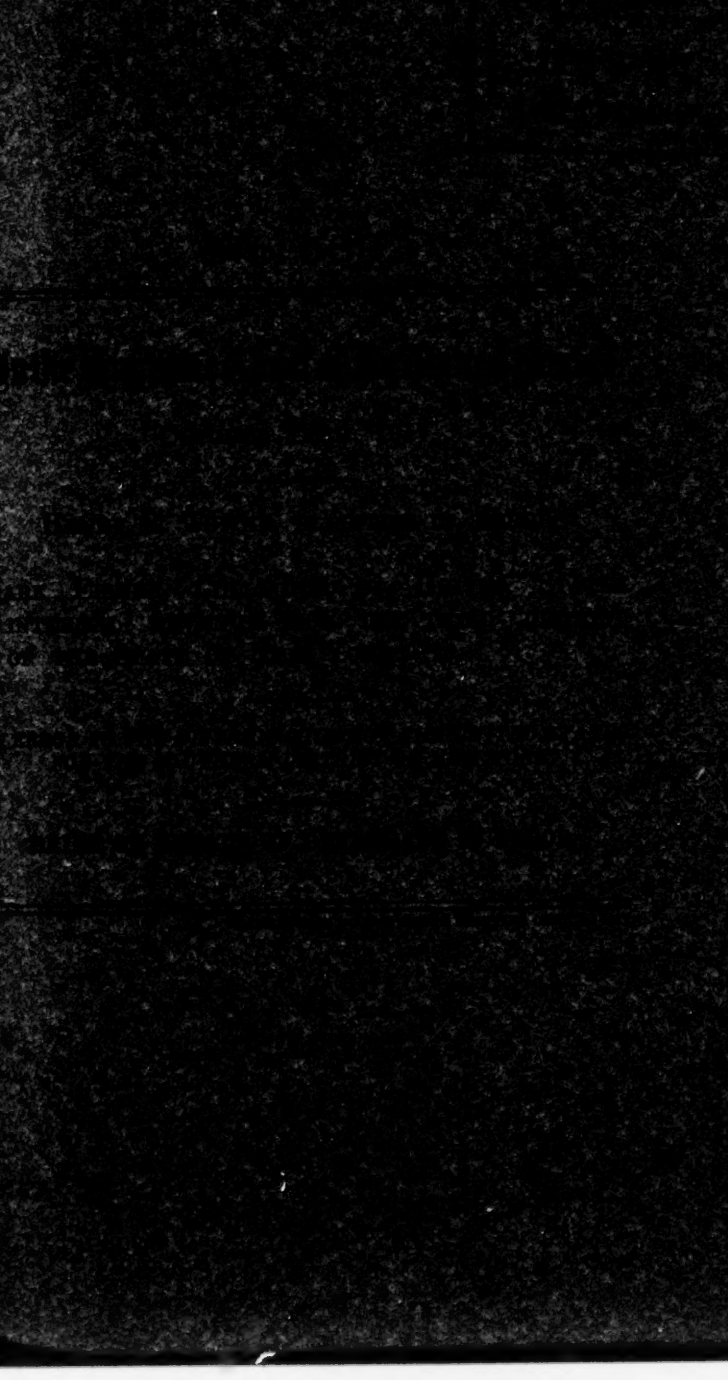
The recent amendment of the Act detracts from the importance of the precedent to be established by the decision in this action; but had there been no amendment, the Treasury Department would be occasioned no inconvenience by, and no evasion of the tax would result from, the construction of the Act here urged. The rule should be established that stock dividends are not taxable; that all other dividends are presumptively taxable, if declared and paid after the effective date of the Act; but that this presumption is *prima facie* and, in a proper case, may be rebutted, the burden of proof being on the taxpayer.

Bailey v. R. Co., 106 U. S., 109, 116.

The spirit and language of the Act and of statutes *in pari materia*, the rules of statutory construction—that of strict construction, that against possible conflict with the Constitution against retroactive effect, against arbitrary and unequal taxation—and justice and fairness are opposed to the construction of the Act contended for by the Treasury Department.

Respectfully submitted,

GORDON M. BUCK,
Amicus Curiae.



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In the Supreme Court of the United States.

OCTOBER TERM, 1917.

HENRY R. TOWNE, PLAINTIFF IN ERROR,	}	No. 563.
<i>v.</i>		
MARK EISNER, COLLECTOR OF UNITED		
STATES INTERNAL REVENUE FOR THE		
THIRD DISTRICT OF THE STATE OF NEW		
YORK.		

*IN ERROR TO THE DISTRICT COURT OF THE UNITED
STATES FOR THE SOUTHERN DISTRICT OF NEW YORK.*

BRIEF ON BEHALF OF DEFENDANT IN ERROR.

I.

**THE WRIT OF ERROR SHOULD BE DISMISSED FOR LACK OF
JURISDICTION.**

This writ of error is prosecuted under section 238, Judicial Code, and the only basis claimed for it is that the case is one "that involves the construction or application of the Constitution of the United States," or is one "in which the constitutionality of a law of the United States is drawn in question." An examination of the record shows clearly, however, that the case does not involve the Constitution of the United

States in the sense required by the uniform decisions of this court, but involves merely the construction of Section II, subsection A, subdivisions 1, 2, and subsection B of the act of October 3, 1913, 38 Stat. 114, 166, 167, c. 16.

The record shows that on January 2, 1914, the Yale and Towne Manufacturing Company issued to its stockholders of record, of whom the plaintiff in error was one, additional certificates of stock to represent accumulated surplus, all of which had been derived from earnings made prior to January 1, 1913. (R. 8, 9, pars. VIII, IX, XI.) The plaintiff in error made no return under the Income Tax Act on account of the receipt of this additional stock; and, therefore, the defendant in error, as collector of internal revenue, purporting to act under the provisions of the act of October 3, 1913, *supra*, and construing that act as covering by the terms "income" and "dividend" this receipt of additional stock by plaintiff in error, demanded of the latter the tax thereon, which he paid under protest and which he now sues to recover back. (R. 9, 10, pars. XII, XIII.) The complaint after setting out these facts, concludes with the allegation that if the act of October 3, 1913, be construed to cover such receipt of additional stock it would violate the Constitution of the United States, and that, therefore, the plaintiff draws in question the constitutionality of said act and of all provisions thereof assumed or asserted to authorize such a levy of tax. (R. 11, par. XVIII.)

The lower court in its opinion (R. 19-24) merely held that this distribution of additional stock constituted income to the plaintiff within the meaning of the act of October 3, 1913, concluding as follows (R. 24):

I can have no doubt that the Act of Congress taxing the dividends in question is constitutional for they possess the real essentials of income.

It is evident that the substantial, if not the only, question in the case was whether this distribution of additional stock constituted income under a proper construction of the act. No claim was made by anybody that the United States had power under the Constitution to tax capital directly without apportionment. The only question was whether this distribution of additional stock was a mere readjustment of capital or whether, on account of the additional advantage derived by the stockholder therefrom, it constituted income. The Constitution may have been appealed to as an aid in the construction of the statute, but the case turned nevertheless upon that construction, and an error made by the court in interpreting the statute must be corrected in the manner provided by law. The constitutionality of the act of October 3, 1913, in so far as it levied a tax on incomes, could not, of course, be drawn in question by anybody since the decision of this court in *Brushaber v. Union Pacific R. R. Co.*, 240 U. S. 1.

The question as to what is "income" and what is "capital" is, it is true, still open in every case, but that is a question to be determined by a construction of the statute and does not, in any true sense, involve the Constitution. Nor does the statement in the complaint that the Constitution is involved and that the constitutionality of a law of the United States is drawn in question help matters. *Lampasas v. Bell*, 180 U. S. 276, 282; *Arbuckle v. Blackburn*, 191 U. S. 405, 415. It is clear that this allegation was inserted merely for the purpose of furnishing a basis for this direct procedure and thus avoiding the legal, commonplace steps of a writ of error from the Circuit Court of Appeals, with a right to apply to this court for a certiorari.

It is submitted that the case falls directly within the rule laid down in the following decisions of this court: *Cornell v. Green*, 163 U. S. 75, 78, 80; *Lampasas v. Bell*, *supra*; *Arbuckle v. Blackburn*, *supra*; *Cosmopolitan Mining Co. v. Walsh*, 193 U. S. 460, 471, 472; *Sloan v. United States*, 193 U. S. 614, 620; *Taylor v. Taft*, 203 U. S. 461, 464; *American Sugar Refining Co. v. United States*, 211 U. S. 155, 161, 162; *Rakes v. United States*, 212 U. S. 55, 58; *Shaw v. United States*, 212 U. S. 559; *Childers v. McClaughry*, 216 U. S. 139; *Norton v. Whiteside*, 239 U. S. 144, 147; *Lamar v. United States*, 240 U. S. 60, 65; *Chin Fong v. Backus*, 241 U. S. 1, 5.

Certain of the more significant of these cases may properly be referred to specially.

In *Arbuckle v. Blackburn*, 191 U. S. 405, the Dairy and Food Commissioner of the State of Ohio ruled that the plaintiff's product was adulterated within the meaning of the State Pure Food Act, and did not come within the proviso exempting articles not injurious to health. It was claimed that if this construction was correct it would render the act unconstitutional. This court dismissed the appeal for the reason that no constitutional question was involved, and said (p. 415):

The suggested controversy was purely hypothetical and based the supposed constitutional objections on the contingency that, on issues of fact, it might be judicially determined that *Ariosa* came within the statute, which complainants denied.

If the commissioner's conclusions were erroneous, the courts were open for the correction of the error, and the possibility that they might agree with the commissioner could not be laid hold of as tantamount to an actual controversy as to the effect of the Constitution, on the determination of which the result of the present suit depended. Indeed, in the only case called to our attention by counsel involving the status of *Ariosa*, the Court of Common Pleas of Lucas County, Ohio, held that it was not within the prohibition of the statute. *White v. Ohio*, 12 Ohio Nisi Prius Decisions, 659.

Reference to the Constitution to strengthen objections to a particular construction, or the

pursuit of a certain course of conduct, is not sufficient to invoke jurisdiction. * * *

In *Cosmopolitan Mining Co. v. Walsh*, 193 U. S. 460, it was claimed that the plaintiff in error had been deprived of its property without due process of law, contrary to the Constitution of the United States, because the statute of Colorado when properly construed permitted a judgment to be rendered against it without proper service. The writ of error was dismissed for lack of jurisdiction, the court saying (pp. 471, 472):

It is obvious, under the construction of the Judiciary Act of 1891, announced in the cases just referred to, that this cause does not involve the construction or application of the Constitution of the United States, and therefore was not entitled to be brought directly to this court from the Circuit Court of the United States. When the proceedings at the trial are taken into view it is clear that the contentions which were urged did not require the construction of the Constitution of the United States, but simply called for the construction of the constitution and laws of the State of Colorado or the application of the principles of general law. * * *

The claim asserted under the Constitution of the United States was, therefore, merely conjectural and amounted to this only, that if under the law of Colorado or under the general law the service on the alleged agent was void, that it would be a violation of the Constitution of the United States to give effect to judg-

ments based on such service. Not only the statement we have made from the record, but the argument at bar, makes this a demonstration. Thus, in the discussion at bar, it was stated that it was not claimed that the State of Colorado could not without a violation of the Constitution of the United States have exacted that the authority conferred by a foreign corporation upon an agent to receive service of process should continue for the purpose of the enforcement of obligations contracted by the corporation, although the corporation had ceased to do business within the State, but that as the Colorado law when properly construed did not so provide, therefore the service was invalid, and the sale of the property of the mining company based on such service was void. This, however, as we have already shown, amounts but to the concession that the substantial controversy which the case presented involved the mere determination of what was the law of Colorado on the subject. The rulings of the court below as to the admissibility of evidence and its final direction of a verdict involved necessarily deciding that the service upon the agent was valid by the law of Colorado, or the principles of general law applicable thereto, and its action in so doing in nowise involved the construction or application of any provision of the Constitution of the United States.

In *Sloan v. United States*, 193 U. S. 614, the complainants brought suit for the purpose of maintaining their rights to certain allotments to Indians granted

by a law of the United States. The act itself referred to a treaty of 1865 between the United States and the Omahas and both the complainant and the United States referred to this and other treaties as part of their case. The appeal was dismissed on the ground that the construction of the treaties was not involved within the meaning of section 238, Judicial Code, the court saying (pp. 620, 621):

* * * The construction of a treaty is used only as an argument upon the issue directly in question, viz, the construction of the statute. The alleged right to an allotment being based upon the act of 1882, and the defence being also based upon the proper construction of that act, we cannot but regard the case as one simply resting on such act. The construction of these various treaties was not substantially or in any other than a merely incidental or remote manner drawn in question, and therefore a direct appeal to this court cannot be sustained.

* * * In order to come within the act of 1891 the treaty must be directly involved, and upon its construction the rights of the parties must rest. Within these cases it cannot be said that the construction of any treaty is drawn in question herein when the rights of neither party are necessarily dependent upon such construction, but are dependent upon that which may be given the statute of 1882, and when the construction of that statute is independent of that which may be given any of the treaties mentioned, although weight may be given to the treaties in determining the question of the construction of the statute.

In *American Sugar Refining Co. v. United States*, 211 U. S. 155, it was claimed that certain regulations issued by the Secretary of the Treasury in regard to customs dues on sugar added something not contained therein to the requirements of the act, and in this way constituted an exercise of legislative power in violation of the Constitution. The court, in dismissing the appeal for lack of jurisdiction, said (pp. 161, 162):

This is conceded, and counsel for appellant attempt to sustain the jurisdiction on the ground that the regulations assumed to add something to the dutiable standard prescribed by the tariff act, and that in doing so the Secretary exercised legislative power confided by the Constitution solely to Congress. But this does not constitute a real and substantial dispute or controversy concerning the construction or application of the Constitution upon which the result depends.

The admitted duty of the Secretary of the Treasury was to construe as best he could the paragraph relating to collection of duty upon sugars, and to promulgate regulations for carrying it into effect. Rev. Stat. §251. This and this alone he did. The only real substantial point involved is whether or not he misconstrued the statute, and that gives this court no jurisdiction upon direct appeal. *Sloan v. United States*, 193 U. S. 614, 620, and cases cited; *United States ex rel. Taylor v. Taft, Secretary*, 203 U. S. 461.

Undoubtedly Congress, without violating any constitutional provision, could have in terms directed exactly what was prescribed by the Treasury regulations; and prior decisions have held that the statute was properly construed by the Secretary.

We concur with counsel for the Government that if the construction or application of the Constitution of the United States, within the meaning of § 5, act of 1891, is involved in every case where one claims that according to his interpretation of a statute excessive duty or tax has been demanded by executive officers, *the provisions of that act making decisions of the Circuit Court of Appeals in revenue cases final are of very limited value, and this court must entertain direct appeals from the Circuit Courts in most tariff and tax controversies, which we regard as out of the question.* [Italics ours.]

The plaintiff in error also claims that the act is unconstitutional if construed to cover dividends, whether in stock or in cash, derived from earnings accumulated prior to the passage of the Sixteenth Amendment. This claim has been, however, so recently and completely denied by the court as to be frivolous at this time. *Brushaber v. Union Pacific R. R. Co.*, 240 U. S. 1; *Stanton v. Baltic Mining Co.*, 240 U. S. 103; *Edwards v. Keith*, 231 Fed. 110, writ of certiorari denied, 243 U. S. 638. Under these decisions, the manner in which, the place where, or the time when the source of the income was created

is immaterial. In *Memphis etc. R. R. v. United States*, 108 U. S. 228, 234, this court said:

The tax is payable by the person because of his income, according to its amount, and without any reference to the way in which it was obtained.

II.

THE COURT BELOW WAS CORRECT IN HOLDING THAT "STOCK DIVIDENDS" ARE TAXABLE UNDER THE PROVISIONS OF THE INCOME TAX ACT OF OCTOBER 3, 1913.

A. The words in the act to be construed by the court are in substance "income arising or accruing from all sources."

The act provides by Section II, par. A, subdivision 1, "that there shall be levied * * * and paid annually upon the entire net income arising or accruing from all sources in the preceding calendar year" a certain tax. Subdivision 2 evidently bases the additional tax upon this same net income. It further provides that "every person subject to this additional tax shall * * * make a personal return of his total net income from all sources, corporate or otherwise, for the preceding calendar year." Paragraph B defines net income as including "gains, profits, and income derived from * * * dividends * * * or gains, or profits and income derived from any source whatever." Paragraph D provides that a true and accurate return should be made by each person of lawful age subject to the tax "setting forth specifically the gross amount of income from all separate sources and from the total thereof."

The case at bar depends upon the proper construction to be given to the above italicized words.

- (1) The term "dividends" denotes merely a species falling within the genus "income," and a definition of the latter term is therefore sufficient.

While the word "dividends" is specifically mentioned in the act, it is only as included in "income." "Income" is the generic term, and, therefore, it is not necessary to discuss the meaning of the term "dividends." The decisive question is whether "stock dividends" are included within the term "income arising or accruing from all sources."

- (2) "Income" is the service rendered a person by his "capital."

"Capital" and "income" are the contrasting terms in this connection, and the distinction between them must be carefully observed. "Capital" represents the wealth or property of a person *at a given instant of time*; i. e., the sum of those rights of his which the law will protect as against all persons. "Income" represents the advantage, service, or use actually rendered by "capital" to its owner *during a period of time*. While the value of "capital" depends upon the potentiality of its enjoyment; i. e., upon the amount of income it will produce, yet the distinction between the two is most important, and especially so in cases like the present, because under our dual system of government the direct taxation of "capital" is, as a general thing, left to the States, while "incomes" are now an important source of revenues to the Federal Government. The property rights of

a stockholder in a corporation, represented by a certificate of stock, while getting their value from the financial advantages which may arise from them from time to time, are an entirely different thing from those advantages themselves which, when they actually accrue, cause a disturbance in "capital," and the creation of new conditions and rights.

(a) "Income" need not be money, but may be any advantage or service capable of easy, accurate, monetary appraisement.

It is claimed by plaintiff in error that "income," as used in the act of October 3, 1913, must be construed to mean "money income" only. (Brief, p. 52.) There appears, however, to be no foundation for this view. The statute nowhere so provides. It speaks of the "entire," the "total" income; words capable in their natural meaning of covering other than "money" income. In addition, paragraph B includes in "income" "the income from but not *the value of property* acquired by gift, bequest, devise, or descent," thus implying that, but for this exception, the *value* of a bequest would be income. It also includes "compensation for personal service * * * *in whatever form paid*"; from "*dealings in property*" as distinguished from "sales" thereof; and from "rent." It must be assumed that Congress was aware that "personal services," and "rents," are often paid in kind, and that "*dealings in property*" may take the form of an exchange; and intended by the above language to cover such cases. Moreover, the deductions permitted by paragraph B include

losses actually sustained during the year, debts ascertained to be worthless and charged off, and a reasonable allowance for the exhaustion of property. These are all things the negative value of which must be more or less a matter of estimate.

That the term "income" would, as a general thing, include the passing of such things as shares of stock has been held by State courts. In *Union etc. Trust Co. v. Taintor*, 85 Conn. 452, it was held that a distribution by a railroad company of stock in another railroad company all of which the former owned constituted "income," the court saying (p. 455):

Cash dividends include all distributions of surplus assets, whether in the form of cash or property, taken from the body of the assets to become the property of the shareholders.

In *Gray v. Hemenway*, 212 Mass. 239, the court made the same ruling as to precisely the same dividends, referring to an earlier case of *Leland v. Hayden*, 102 Mass. 542, 551, where the court said of such a transaction:

In substance, as well as in intent, it was a cash dividend, though it was not such in form; and the substance and intent must govern the transaction.

- (3) There is a strong presumption that the distribution of this stock dividend was an advantage to the stockholders from the fact that they desired it and passed the resolutions directing it.

The record shows that the matter of making this stock dividend received the fullest consideration from all parties concerned. A committee appointed

by the directors of the company submitted a carefully worked-out plan which was referred to and adopted by the stockholders and executed by the directors. Since the subject matter was of a business, financial character engaged in by business men, it must be assumed that the corporation intended to confer, and the stockholders to receive, some advantage of a business nature. If, as the plaintiff in error claims, the corporation gave up and the stockholders gained no advantage of a financial nature, there was certainly much ado about nothing. The Government, in assessing its tax, has a right to assume that the parties acted on the motives normally governing men of business, and, therefore, contemplated, and probably effected some tangible business advantage by this procedure.

(4) These advantages were as follows:

- (a) A transfer of the surplus and undivided profits from the plenary control of the corporation to a control largely in the stockholder.

It is undoubtedly true that the term "capital stock" has a colloquial meaning broad enough to cover "surplus" and "undivided profits," and that a stockholder, as such, has a legal interest in such "surplus" and "undivided profits." The more common meaning of "capital stock," however, is confined to the "capital" authorized by law and subscribed by the stockholders, and this is the sense in which the term is always used by accountants and in reports. This restricted meaning is based upon a real distinction between "capital" and "surplus."

As said by the court in *Farrington v. Tennessee*, 95 U. S. 679, 686:

* * * The capital stock is the money paid or authorized or required to be paid in as the basis of the business of the bank, and the means of conducting its operations. It represents whatever it may be invested in. If a large surplus be accumulated and laid by, that does not become a part of it. The amount authorized cannot be increased without proper legal authority. If there be losses which impair it, there can be no formal reduction without the like sanction. No power to increase or diminish it belongs inherently to the corporation. It is a trust fund, held by the corporation as a trustee. It is subject to taxation like other property. If the bank fail, equity may lay hold of it, administer it, pay the debts, and give the residuum, if there be any, to the stockholders. If the corporation be dissolved by judgment of law, equity may interpose and perform the same functions.

* * *

Both the "capital" (in this common sense) and the "surplus" belong to the corporation; and the stockholders have legal rights as to both, but these rights are less complete in regard to the latter than in regard to the former. The right as to the "capital" (in the common sense) is that it shall be held intact, and that dividends shall be paid upon it when conditions justify. In addition, of course, there is the important right of voting which may carry with it the control of the corporation. As to

the surplus, however, there is merely a right that the directors shall deal with it in good faith. Indeed, one of the prime reasons for maintaining a surplus is that it is more fluid, less under the control of stockholders, and more easily dealt with by the directors. When, therefore, the surplus is transformed into "capital" (in the common sense) and certificates of stock issued therefor, a real change takes place, a new condition and new rights are created. The stockholder now has a direct right in what was "surplus" or in some exactly specified portion of it, which is represented by the new certificates. This new "capital," like the old, must be held intact, and has a right to dividends when conditions justify. The right of voting is increased, and while at first sight this might not seem to be an advantage, experience apparently shows that where the amount of stock outstanding is large, it will find its way into the hands of small holders who are content to give proxies to dominant holders, so that the owner of a large amount of stock may sell a considerable portion of it and yet retain unaffected his control of the corporation. All this change of condition and creation of new rights is graphically expressed in the bookkeeping entries. Whereas before the corporation was indebted to "surplus" it is now indebted to "capital." These entries represent a real change in the obligations of the corporation, and a new condition of affairs which would be recognized by any business man.

- (b) An assurance that a declaration of dividends would in the future specifically take account of this surplus and be declared upon it.

This has been briefly indicated above. There must necessarily be a constant pressure on the directors to pay dividends on the outstanding stock, new as well as old, and, therefore, a probability that greater dividends as a whole will be declared in the future than in the past.

- (c) A muniment of title which enables the stockholder to deal easily with his interest in the surplus by mere assignment of his new stock.

Whereas before the payment of the stock dividend the stockholder could only point to the "surplus" as something contained in the statements and reports of the corporation, and in which he had an interest of a more or less speculative nature, he now can show a duly authorized and issued certificate of stock representing a specific, delimited portion of the "surplus." Thus greater availability is given to his interest in the "surplus." He has now a muniment of title thereto so that he may easily dispose of his interest in the surplus by mere assignment and transfer on the books of the corporation, whereas before he would either have to assign his interest in the original capital as well, or have his shares split up with no assurance that any portion of the surplus would ever be set aside to cover any particular shares. The same advantage would accrue if he desired to borrow money by hypothecation of his shares. In short, he is now able to exhibit to the business world in tangible shape his legal rights in the "surplus."

This muniment of title, this right to dispose of his interest in the surplus and thus permit other persons to share in the future of the corporation, is a real advantage of great value. It must be remembered that a successful corporation, such as issues stock dividends, has a prestige, has attained a favorable, forward position which can not be exactly represented by figures in its "assets" account, but which is nevertheless very real, and that, therefore, the privilege of becoming a member of such a fortunate venture, of buying, through the purchase of newly issued shares, an entrance into its control is eagerly sought for. For this reason merely theoretical notions to the effect that a stock dividend does not confer any advantage upon the stockholder, do not square with the universal opinions of the business world or of the stockholders themselves. In *in re Evans* (1913), 1 Ch. 23, 30, 31, NEVILLE, J., used the following language:

* * * The result of transferring the undivided profits standing to the credit of the reserve fund to the credit of newly issued capital of the same amount would theoretically be to halve the value of each share; that is to say, taking imaginary figures, if you have 1,000 shares of 10*l.* each representing assets, including among the assets the accumulated profits which had been invested, and you thereupon issue another 1,000 shares of 10*l.* each, transferring the amount standing to the credit of the reserve fund to the credit of the face value of the new shares, you would

then get, as a matter of account, a sum representing capital instead of a sum representing the reserve fund; and it is obvious you would have increased the capital of the company, but you would not have increased the assets of the company by a penny. Consequently, that which had to be divided previously between 1,000 shares would now have to be divided amongst 2,000 shares. Therefore the two shares would receive exactly the same amount on distribution as the one share received previously. *That, of course, is a theoretical way of looking at it. Experience, I think, shews that in a prosperous concern of this kind the shares are not reduced very substantially in value by this alteration. There are plenty of persons willing to come into a concern of this kind, and to pay a premium for the new shares, notwithstanding the fact that the share capital has been doubled, the assets remaining the same. * * ** [Italics ours.]

- 5) These advantages constitute "income" to the stockholder because they flow to him from his property rights (i. e. "capital") in the corporation, and are capable of easy, accurate, monetary appraisement.

(a) That they flowed to him from his "capital" is obvious since they came to him because of his ownership of a portion of the original capital stock of the corporation, and for no other reason.

(b) That they were capable of easy, monetary appraisement is shown conclusively by the statement in the record that there was a regular market quotation upon them.

(c) It is true that the record shows the old stock fell in value upon the issuance of the new shares, but

if the new shares constituted gross income, the fall in the old shares would have to be treated, if it could be considered at all, as a deduction from such gross income, and no such claim is or ever has been made. Looked at as a deduction, it could not be claimed until the old shares were actually sold, and *non constat* but that when such sale is made, no loss at all will be suffered.

(6) Argument of the plaintiff in error stated and answered.

(a) That this "surplus" always belonged to the stockholder.

Answer. This is true, but it did not belong to him in the strict sense and to the full extent of control obtaining in the case of the original capital. Hence, the specific transfer of the surplus to him by resolution and issuance of certificates, putting it on a par with the original capital, created new rights in the stockholder.

(b) The corporation lost nothing.

Answer. It lost its plenary control over the "surplus." Instead of being indebted to "surplus," with a consequent free use of such funds, it became indebted to "capital," with a limited use of the funds.

(c) The stockholder gained nothing.

Answer. He gained a direct right against the corporation evidenced by his new certificates instead of an indirect interest in the "surplus."

(d) The surplus was put in a position where it could not be distributed as dividends or income.

Answer. It gained this position, however, by distribution, i. e., by conversion into capital. It passed to the stockholder as income en bloc, and

could not of course produce income again in that form until another complete change took place.

(7) The authorities bearing upon the subject considered.

In the case of *Gibbons v. Mahon*, 136 U. S. 549, it was held that stock dividends went to the remainderman under a trust which gave the income ("dividends") of certain stock to one person for life and the stock itself to another on the life tenant's death. The plaintiff in error properly relies greatly on this authority. It must be noted, however, that the question of the apportionment of stock dividends between a life tenant and remainderman is largely dependent on equitable considerations. The object of the law is to make a fair distribution of the testator's estate among those claiming from the same source successive interests therein. For this reason even an extraordinary dividend in cash or in stock of other corporations might be held to belong equitably to the remainderman. In effect the *ratio decidendi* of *Gibbons v. Mahon* was that the matter should be left to the determination of the corporation itself, as this would probably most fairly accomplish the testator's intention.¹

¹ The statement made in *Gibbons v. Mahon* at page 567 that the rule permitting the division of stock dividends, as between life tenant and remainderman, on equitable principles prevails only in Pennsylvania, New Jersey, and New Hampshire, does not seem to be correct at present, as shown by the following decisions: *Bryan v. Aiken*, 86 Atlantic 674 (Del.); *Kalbach v. Clark*, 133 Iowa 215; *Hite v. Hite*, 93 Ky. 257; *Gilkey v. Paine* (apparently), 80 Maine

In the case of taxation, however, equitable considerations have no place. A statute levying a tax must be rigorously applied according to its correct construction, no matter what hardships may be caused thereby. Hence it does not follow that a decision as to what is income to a life tenant under a will is conclusive as to what is income for purposes of taxation. This seems to be recognized in *Gibbons v. Mahon* at page 560, where, discussing the case of *Bailey v. Railroad Co.*, 22 Wall. 604 (referred to later in this brief), it is said:

The question at issue [in *Bailey v. R. R. Co.*] was not between the owners of successive interests in particular shares, but between the corporation and the government, and depended upon the terms of a statute carefully framed to prevent corporations from evading the payment of the tax upon their earnings.

In *Logan County v. United States*, 169 U. S. 255, it was held that a tax paid by the L. & N. R. R. Co., under the provisions of section 122 of the act of June 30, 1864, upon its undistributed surplus was not a tax on a stock dividend subsequently declared out of that surplus and paid to Logan County. There are ex-

319, 325; *Thomas v. Gregg*, 78 Md. 545, 559; *Goodwin v. McGaughey*, 108 Minn. 248; *Matter of Osborne*, 209 N. Y. 450; *Cobb v. Fant*, 36 S. C. 1; *Pritchitt v. Nashville Trust Co.*, 96 Tenn. 472; *Soehnlein v. Soehnlein*, 146 Wis. 330; *Cook on Corporations*, 7th ed., sections 552, 553, 554; *Thompson on Corporations*, section 5397, pp. 191-192; *Perry on Trusts*, 6th ed., section 545; *Loring, Handbook for Trustees*, pp. 127 to 134.

pressions in the opinion (pp. 261, 262, 263), to the effect that a stock dividend distributes nothing and that by it the corporation loses and the stockholder gains nothing. It would appear, however, that these remarks are *obiter dicta*, since the tax was in fact levied on the corporation with respect to the undistributed surplus, and not at all on the stockholders with respect to their income, and the fact that the payment of the tax may have affected the amount subsequently paid as stock dividend was immaterial. In other words, the decision would have been the same had the subsequent dividend been in cash. Indeed the court expressly states (p. 261) that under the statute the stock dividend in question was a proper subject of taxation.

Going back to the case of *Bailey v. Railroad Co.*, 22 Wall. 604, S. C. 106 U. S. 109, it was undoubtedly held in the first error proceedings that a stock dividend was, and could lawfully be, taxed under the Income Tax Act of 1864. (The dividend was in "scrip" but evidently this makes no difference). The question whether such dividends were in truth income seems to have been argued and determined by the court (*vide* pp. 636, 637, 638), and *State v. The Farmers' Bank*, 11 Ohio 94, is relied on where the court said (p. 95):

Whenever, by the act of the directors. the ownership of profits is so changed, that it ceases to be the property of the corporation, and becomes the property of the stockholder, it is a dividend of profits, upon which the tax was intended to apply.

It is true that the act of 1864 expressly taxed dividends in scrip (in the same clause as dividends in money), but, subject to what will be said later, unless such dividends were in effect "income," there would have been necessarily grave doubt as to the power to tax them in this way. Evidently this court at the first hearing treated them as "income."

The plaintiff in error attempts to dispose of this decision in two ways:

(a) It is argued that, according to the final ruling of this court, the tax in question was, in reality, an excise on the corporation itself with respect to the scrip dividends declared, and hence it was not necessary for this court to hold that such dividends were income to the stockholders.

(b) It was held on the second proceedings in error that the law did not apply to scrip dividends representing earnings accumulated prior to the passage of the Income Tax Act, and that, as the dividend in the case at bar represented earnings accumulated prior to the passage of the Sixteenth Amendment, the decision in the *Bailey* case is in reality in favor of the plaintiff in error.

With reference to (a) it may be said that this argument can not be made as to the *Bailey* case itself, for on the second hearing the ruling on the first that a stock dividend was liable to an income tax was affirmed, and it was stated that while there had been a difference of opinion in the court as to whether the tax was on the corporation or on the

stockholder, "in the present case it is immaterial which of these alternatives is adopted" (page 116).

The plaintiff in error refers to certain cases in this court (brief, pp. 35-37) and states that the final conclusion reached, as shown by *Railroad Co. v. Collector*, 100 U. S. 595, and *United States v. Erie Ry. Co.*, 106 U. S. 327, was that the statute levied an excise tax on the corporation in respect of the dividends declared.

It is true that in the former of these cases it was so held—though upon no very clear grounds—and that this holding is affirmed without discussion in the latter, and referred to (though the point apparently was not involved) in *Memphis etc. R. R. Co. v. United States*, 108 U. S. 228, 234.

In *United States v. Railroad Co.*, 17 Wall. 322, however, this same tax was held unconstitutional as against the city of Baltimore, which was a stockholder in the corporation, because it amounted to taxation of a State agency, and this case, apart from being a leading authority, is affirmed on the same point in *Logan County v. United States*, 169 U. S. 255, 256, where this court could not have considered the claim of Logan County at all if it had followed the rule laid down in *Railroad Company v. Collector*, *supra*. So the tax levied by States upon national banks on account of the shares of stock held therein has always been held to be a tax upon the shareholders. *National Bank v. Commonwealth*, 9 Wall. 353, where on page 363 the tax is said to be the same as that levied by

Congress on dividends and the income from bonds of corporations; *Citizens National Bank v. Kentucky*, 217 U. S. 443; *National Bank of Commerce v. Allen*, 211 Fed. 743; *Eliot National Bank v. Gill*, 218 Fed. 600; *First National Bank v. McNeel*, 238 Fed. 559. It is submitted, therefore, that this court has never really decided that the tax levied on dividends by the act of 1864 was a tax on the corporation, and that on principle it can not be so considered, since a tax upon a "dividend due or payable" to the stockholder is a tax upon a debt due from the corporation, and a tax upon a debt, *eo nomine*; is substantially a tax upon the creditor, especially where, as in the act of 1864, the debtor is authorized to withhold the amount of the tax.

The first objection, therefore, of the plaintiff in error to the authority of *Bailey v. Railroad Co.* does not seem to be well taken.

As to argument (b), it is true that in the second *Bailey* case it was held that no tax could be levied on dividends derived from earnings accumulated prior to the passage of the act, and that, if this rule be applicable to the present case, the plaintiff in error would not be liable to the tax, even if the dividend had been in cash, because the earnings from which it was paid were made prior to March 1, 1913. The act of 1864, however, under which the *Bailey* case arose, provided by section 116 that there should be levied a tax upon the annual gains, profits or income, and, while this phrase "annual gains" does not occur in

section 122 it is undoubtedly implied. Consequently the court said (p. 114):

It should be borne in mind, in the first place, that the tax provided for in this section is an annual income tax, and its subject is the interest paid and profits earned by the company for each year, and year by year; and that both by the express letter of the law, and its necessary implications, the tax is not laid on any of these funds which came into being before the time prescribed in the act.

This meaning of the Civil War Income Tax Acts is again brought out in *Gray v. Darlington*, 15 Wall. 63, 65, where the court said about the somewhat more doubtful language of the act of March 2, 1867:

This language has only one meaning, and that is that the assessment, collection, and payment prescribed are to be made upon the annual products or income of one's property or labor, or such gains or profits as may be realized from a business transaction begun and completed during the preceding year.

Under this construction, no other conclusion than the one reached in the second *Bailey* case was possible.

No such construction can, however, be placed upon the act of October 3, 1913. Article XVI of the amendments expressly conferred power to levy a tax on incomes "from whatever source derived," and that Congress intended to exercise this power up to its furthest permissible limits is shown by its definition of the subject of the tax as "the entire net income arising or accruing from all sources in the preceding

calendar year," and "the gross amount of income from all separate sources and from the total thereof." Under this language the element of time is introduced in connection with the receipt of the income, not in connection with the time when the earnings were actually made. The manner in which, or the time when the source from which the income accrued was created is, by express provision of law, made immaterial, and the only test fixed is the time of the actual receipt of the income. Consequently, this court held in *Brushaber v. Union Pac. R. R. Co.*, 240 U. S. 1, that income accrued prior to the passage of the act could be validly taxed, though, of course, it had become capital prior to that time, and indeed must have been derived in many cases from capital accumulated prior to the passage of the amendment; and in *Stanton v. Baltic Mining Co.*, 240 U. S. 103, that income of a mining company was taxable though the capital from which it was derived had no doubt been accumulated ages prior to the passage of the amendment. In *Edwards v. Keith*, 243 U. S. 638, this court refused a certiorari in a case where the right to the income had accrued prior to the passage of the amendment, though the income was actually received later, and the very claim now made by the plaintiff in error, namely, that the act did not or could not tax income derived from capital accumulated prior to the passage of the amendment, was asserted in the petition for the writ of certiorari. This view had support even under the Civil War

Income Tax Acts. In *Memphis etc. R. R. Co. v. United States*, 108 U. S. 228, it was claimed that the income could not be taxed because the property from which it was derived was within the rebel lines. This court denied the claim, saying (p. 234):

To our minds it is a matter of no importance that the income came from property which was within Confederate territory. * * * In both cases the tax is in legal effect on the income of persons subject to the actual control and dominion of the United States. *The tax is payable by the person because of his income, according to its amount, and without any reference to the way in which it was obtained.* [Italics ours.]

It seems clear, therefore, that the decision in the second *Bailey* case can not be considered an authority on the construction of the act of October 3, 1913, in so far as it holds that the time when the earnings were accumulated is material. Therefore the decision in the first *Bailey* case remains unaffected by the objections of the plaintiff in error and is entitled to its full force as a holding that a stock dividend is a proper subject of taxation under an income tax. If it be such a subject, it can only be because it is, in its nature, included in the term "income," since the act of 1864 did not purport to levy anything but an income tax, even if Congress had power to do more. Hence the decision in the first *Bailey* case seems in point on the construction of the term "income" in the act of October 3, 1913.

Reviewing, then, the decisions of this court in the first *Bailey* case, in *Gibbons v. Mahon*, and in *Logan County v. United States*, comparing them, and considering carefully the due weight to be given to each as an authority in the case at bar, it is submitted that the question whether a stock dividend is "income" within the meaning of an act taxing "net income arising or accruing from all sources" is not foreclosed by authority. It may, therefore, be determined by the principles properly applicable to the subject. What these are we have endeavored to indicate in an earlier part of this brief.

CONCLUSION.

The writ of error should be dismissed for lack of jurisdiction, or the judgment of the court below should be affirmed.

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